upB. ufficio parlamentare di bilancio

2017 Budgetary Policy Report

November 2016

The Report has been published with information updated to 14 November 2016.
The electronic version can be downloaded from: www. upbilancio.it

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FOREWORD

The Report examines the fiscal policy documents and the Budget Bill for 2017, re-presenting here the reports to the appropriate parliamentary committees in hearings held on 3 October and 7 November, with additions and further developments.

The Report is organised into four chapters. The first addresses the macroeconomic environment, while the second examines the trend and policy scenarios for the public finances and the structure of the measures in the 2017 Budget Bill. The third chapter assesses compliance with national and European fiscal rules and the fourth focuses on an analysis of the main budget measures.

The macroeconomic scenario set out in the Draft Budgetary Plan (DBP) is based on a more expansionary budget package for 2017 (0.3 percentage points) than that assumed in September in the Update to the Economic and Financial Document (the Update). The Parliamentary Budget Office (PBO) found that the macroeconomic forecasts proposed by the Government in the DBP were plausible, validating the macroeconomic scenario in the 2016-2017 DBP. At the same time, we found that the current economic environment contained risks that could affect the growth assumptions for 2017 and subsequent years. As part of the validation exercise, the PBO assessed the macroeconomic effects of the measures that make up the budget package: it would produce faster GDP growth, compared with the trend, of about 0.3 percentage points in 2017, compared with the difference of 0.4 percentage points assumed in the DBP.

The risk factors shadowing the macroeconomic scenario are mainly of external origin. The uncertainty has been heightened by the outcome of the recent US presidential election. The reaction of investors triggered a rapid increase in US long-term interest rates, with spillover effects on the yields of European government securities and a widening of spreads with respect to the German benchmark. It is still too early to assess the scope of these developments. When the uncertainty has moderated, it will be necessary to verify whether the macroeconomic scenarios produced before the US elections remain valid.

Compared with the trend developments in the public finances, the measures in the 2017 Budget Bill (supplemented by Decree Law 193/2016) increase borrowing by 0.7 points of GDP in 2017, 0.4 points in 2018 and 0.2 points in 2019. For 2017, easily the largest measure is the cancellation of the increase in VAT rates and excise duties (the so-called “safeguard clauses”), which amounts to 0.9 per cent of GDP (€15.4 billion). Taken together, the other measures will therefore produce a reduction in borrowing of 0.2 points of GDP, or about €7.3 billion in higher net expenditure and €10.6 billion in higher net revenue. The scenario for 2018 and 2019 reflects the retention of the increase in VAT rates in 2018 and a further increase of 0.9 points in the standard rate in 2019. Together, these measures should yield revenue of €19.6 billion in 2018 and €23.3 billion in 2019, equal to 1.1 and 1.3 per cent of GDP respectively.

Overall, the impact of the measures on the public finances is not without risk. Not so much because of the increase in deficit capital spending, given the non-permanent nature of these expenditure and the effects they could have on economic growth, but rather because of the creation of permanent commitments for current expenditure (especially for pensions and public-sector employment) only partially offset by permanent and certain revenue flows. In particular, retaining the increase in the VAT rate and, indeed, raising it further in 2019 in order to ensure the public finances remain sound makes it difficult to discern the medium-term budgetary planning objectives. For the second consecutive year, the most significant budget measure is the cancellation of the increase in VAT rates for the subsequent year. Assuming the Government intends to deactivate the clause again in the following years, the same scenario seems destined to be repeated in future budgets.

The consistency of the public finance scenario with the rules on the structural balance and expenditure depends on at least two factors associated with the European Commission's assessment: a) the recognition of the costs associated with the flow of refugees and those relating to earthquake proofing as exceptional and their consequent exclusion from the structural balance; b) the size of the correction the country must make in relation to economic conditions- normal or bad times - as measured by the output gap. In the event of a favourable solution to both of these issues (recognition of the impact of exceptional events and the fact that the country is going through bad economic times), the objectives in the DBP would represent a close-to-significant deviation for the structural balance rule and an insignificant deviation for the expenditure benchmark. If the events are not recognized as exceptional, the DBP objectives would be at risk of a significant deviation for both public finance parameters. The debt reduction objectives in the DBP do not appear consistent with any of the criteria used (backward-looking, forward-looking and adjusted for the cycle) to assess compliance with the associated numerical debt reduction rule. Compliance with that rule therefore depends on consideration of the relevant factors.

The Budget Bill and the Tax Decree contain, on the one hand, a number of broad provisions to support the capitalisation and growth of firms, increase the neutrality of tax treatment with respect to the legal form of taxpayers, foster a revival of investment and counter tax evasion. On the other hand, they also contain more piecemeal measures pursuing diverse objectives that are difficult to place within a comprehensive vision (those regarding families, young people and anti-poverty mechanisms). The quantification of the measures presented in the technical reports accompanying the Budget Bill and the Tax Decree, while generally plausible, are exposed to risks, especially on the revenue side.

1. THE MACROECONOMIC SCENARIO OF THE DRAFT BUDGETARY PLAN

The macroeconomic scenario set out in the Draft Budgetary Plan (DBP) is based on a more expansionary budget package for 2017 (0.3 percentage points) than that assumed in September in the Update to the Economic and Financial Document (the Update). The expansionary revision of the budget measures did not involve a change in the growth rate forecast for 2017 (1 per cent, as in the Update) The inflation outlook and growth in nominal GDP are also similar to those in the Update. Considering the expansion of the budget package compared with that set out in the Update, the Parliamentary Budget Office (PBO) found that the macroeconomic forecasts proposed by the Government in the DBP were plausible, validating the macroeconomic scenario in the 2016-2017 DBP. At the same time, we found the current economic environment contained risks that could affect the growth assumptions for 2017 and subsequent years.

As part of the validation exercise, the PBO assessed the macroeconomic effects of the measures that make up the budget package. Overall, it would produce faster GDP growth, compared with the trend, of about 0.3 percentage points in 2017, compared with the difference of 0.4 percentage points assumed in the DBP. In the PBO simulation, the measures would boost growth by 0.3 percentage points in 2018 as well. By contrast, growth would slow by about 0.1 percentage points in 2019.

The risk factors shadowing the macroeconomic scenario are mainly of external origin. The uncertainty has been heightened by the outcome of the recent US presidential election. The reaction of investors triggered a rapid increase in US long-term interest rates, with spillover effects on the yields of European government securities and a widening of spreads with respect to the German benchmark. It is still too early to assess the scope of these developments. When the uncertainty has moderated, it will be necessary to verify whether the macroeconomic scenarios produced before the US elections remain valid.

A significant question mark about the international scenario regards developments in world trade. The elasticity of trade to global output has already declined appreciably in recent years for both cyclical and structural reasons. This development could accelerate if the arrival of the new US administration should accentuate global protectionist tendencies. The PBO takes account of the possibility of structurally slower growth in trade in a simulation based on a lower growth rate for trade than that assumed by the Government for 2017-2019. The slowdown in international trade could depress Italian growth as a result of lower foreign demand and keep domestic inflation too low as a result of weaker growth. Slower real growth and lower inflation would produce slower growth in nominal GDP that that assumed in the DBP for the entire forecasting period.

1.1 From the Update scenario to that in the DBP

The macroeconomic scenario in the DBP differs from the policy scenario in the Update in two respects: 1) the inclusion of information on economic developments in 2016 that became available after the publication of the Update (27 September) in the forecasts, with specific reference to the quarterly national accounts data published by Istat on 3 October; 2) a more expansionary budget package that that set out in the Update. Specifically net borrowing is increased as a percentage of GDP from the 1.6 per cent in the scenario on a current legislation basis to 2.3 per cent in the DBP scenario, rather than the 2 per cent assumed in the policy scenario in the Update (see Chapter 2). While the new economic information mainly impacts the estimates for 2016, the modification of the budget measures also affects the forecasts for 2017 and subsequent years.

Before examining the Government's new macroeconomic scenario, it could be helpful to briefly review the steps in the validation exercise conducted by the PBO that preceded the assessment of the macroeconomic scenario in the DBP. On 26 September the PBO validated the trend macroeconomic scenario for 2016-2017 published in the Update. This came after the PBO had announced, on 14 September, its comments on an earlier provisional version of the Government forecasts. The Government took account of those comments in preparing the definitive trend scenario, which was therefore validated by the PBO.

The PBO did not feel it could validate the 2017 policy scenario published in the Update, as the forecasts, as discussed in the parliamentary hearing of 3 October on the Update, were out of line with the interval of projections produced by the PBO panel forecasters. More specifically, the impact of the 2017 budget assumed in the Update (an increase of fourth-tenths of a point in the deficit/GDP ratio between the trend and policy scenarios) on growth in 2017 (an increase of four-tenths of a point, from 0.6 per cent to 1 per cent, in the GDP growth rate between the trend and policy projections) was found to be excessively optimistic, as it was larger than that forecast by the PBO panel (which is composed of CER, Prometeia and REF.Ricerche, as well as the PBO itself).

The expansionary revision of the budget package in the DBP (with the increase of seven-tenths of a point in the deficit/GDP ratio between the trend and policy scenarios) prompted the Government to revise the policy macroeconomic scenario, while still confirming forecast real growth in 2017 at 1 per cent, the same as that envisaged in the Update with less expansionary budget measures. The PBO re-assessed the new macroeconomic scenario in the DBP, using its normal approach. More specifically, the PBO panel forecasters first verified and recalculated their trend forecasts in the light of Istat's quarterly data, then they inserted the new budget measures into those scenarios, generating the corresponding new policy scenarios.

Following this additional analysis, the DBP forecasts for the two-year period were considered plausible and, accordingly, on 17 October the PBO sent the Ministry for the Economy and Finance (MEF) its validation letter for the 2016-2017 policy macroeconomic scenario, reporting the positive outcome of the procedure (http://www.upbilancio.it/wp-content/uploads/2016/10/Lettera-validazione-QMP-DBP-2017.pdf). Although the validation itself covered only the 2016-2017 period, the PBO

nevertheless assessed the realism of the Government's forecasts for the subsequent years (2018-2019) outside the validation process.

In the following we briefly review the key elements of the DBP forecasts, the main differences in 2016-2017 compared with the policy scenario in the Update and the findings of the PBO in the new validation exercise.

1.1.1 The 2016 macroeconomic scenario

For 2016, the DBP macroeconomic scenario's estimates of real growth (0.8 per cent), the GDP deflator (1 per cent) and, therefore, nominal GDP (1.8 per cent) are unchanged on those assumed in the Update (Table 1.1). However, a number of changes were made to the estimates of the components of aggregate demand and, slightly, the deflators.

Taking account of developments in the first two quarters of 2016, the DBP forecasts a smaller negative contribution from net foreign demand than that assumed in the Update (-0.1 percentage points, compared with -0.3 points in the earlier forecast). This is attributable to better performance from exports (four-tenths of a points more than expected in September) and a smaller increase in imports (two-tenths of a point less). Compared with the Update, the DBP also estimates a slightly larger positive contribution from final domestic demand (i.e. net of inventories), amounting to 1.2 percentage points, compared with 1.1 points previously, reflecting slightly faster growth in private consumption, general government spending and investment (one-tenth of a point each). By contrast, the contribution of inventories is less favourable than the estimates set out in the Update in September (-0.4 percentage points, compared with -0.1 points). On the inflation front, the DBP assumes small increases compared with the Update in the consumption and export deflators (both one-tenth of a point higher), offset by a modest decline in the deflator of general government consumption (one-tenth of a point). Overall, these changes tend to offset one and other, leaving the GDP deflator unchanged compared with the Update.

The DBP's assumptions concerning the components of demand differ only marginally from the forecasts of the PBO panel. The latter essentially estimate a slightly smaller contribution from final demand and a less negative contribution from inventories.

Consequently, the DBP estimates for growth in real GDP, the GDP deflator and nominal GDP for 2016 fall within the forecasting interval of the PBO panel, as they had on the occasion of the Update.

Table 1.1 – Differences between the DBP macroeconomic scenario and the Update policy scenario
(percentage points)

	2016		2017		*Diff. DBP-Update*	
	DBP	Policy Update	DBP	Policy Update	*2016*	*2017*
Growth and components of demand						
GDP	0.8	0.8	1.0	1.0	*0.0*	*0.0*
Imports	2.1	2.3	3.6	3.3	*-0.2*	*0.3*
Final domestic consumption	1.1	1.0	0.9	0.8	*0.1*	*0.1*
Consumption of households and non-profit institutions serving households	1.3	1.2	1.0	1.0	*0.1*	*0.0*
General government expenditure	0.5	0.4	0.7	0.5	*0.0*	*0.2*
Investment	2.0	1.9	2.9	3.2	*0.1*	*-0.3*
Exports	1.7	1.3	2.5	2.5	*0.4*	*0.1*
Contributions to GDP growth						
Net exports	-0.1	-0.3	-0.3	-0.2	*0.2*	*-0.1*
Inventories	-0.4	-0.1	0.0	0.0	*-0.3*	*0.1*
Domestic demand net of inventories	1.2	1.1	1.2	1.2	*0.1*	*0.0*
Prices						
Import deflator	-3.4	-3.4	1.3	1.5	*0.0*	*-0.2*
Export deflator	-0.7	-0.8	1.7	1.6	*0.1*	*0.2*
GDP deflator	1.0	1.0	1.0	0.9	*0.0*	*0.1*
Nominal GDP	1.8	1.8	2.0	1.9	*0.0*	*0.1*
Consumption deflator	0.1	0.1	0.9	0.9	*0.1*	*0.0*
Labour market						
Labour costs	0.5	0.5	1.2	1.2	*0.0*	*0.0*
Productivity (percentage of GDP)	-0.1	-0.2	0.3	0.3	*0.0*	*0.0*
Unit labour costs (percentage of GDP)	0.7	0.7	0.9	0.9	*-0.1*	*0.0*
Employment (annual labour units)	0.9	0.9	0.6	0.6	*-0.1*	*0.0*
Unemployment rate	11.5	11.5	10.8	10.8	*0.0*	*0.0*

Source: DBP, October 2016; Update, September 2016.

1.1.2 The 2017 macroeconomic scenario

As noted earlier, the DBP forecasts for 2017 differ from those in the policy scenario in the Update, mainly because they are based on a different budget package, one that is 0.3 percentage points more expansionary than that proposed in September. In the Government’s forecasts, the revision of the budget measures does not appear to have had a significant impact on the expected macroeconomic scenario. The forecast for GDP growth in 2017 remains at 1 per cent, with only limited adjustments to the composition of demand (Table 1.1).

The contribution of net exports to the change in GDP becomes slightly more negative (one-tenth of a point), owning to faster import growth, which outpaces the slightly faster growth in exports. The contribution of inventories is slightly more favourable (one-tenth of a point). The contribution of final domestic demand remains nil, reflecting divergent changes in investment (accelerating by three-tenths of a point less than assumed in the Update policy scenario) and

general government expenditure in volume terms (which is expected to expand by two-tenths of a point more than assumed in the Update).

There are a number of changes in deflators, albeit small ones. The DBP reflects a larger improvement in the terms of trade than that assumed in the Update policy scenario, the result of more a rapid rise in export prices (two-tenths of a point) and slower growth in import prices (two-tenths of a point). Partly as a result of these changes, the GDP deflator in the DBP (1 per cent) is slightly higher than that posited in the Update (one-tenth of a point), despite virtually no change in the household consumption deflator. Given real GDP growth and the change in the GDP deflator, the growth in nominal GDP assumed in the DBP (2 per cent) is slightly higher than the forecast in the Update (one-tenth of a point more).

The main findings of the PBO's validation exercise for 2017 are shown in Figure 1.1. Unlike the policy scenario in the Update, real GDP growth lies within the new range of forecasts of the PBO panel (equal to 0.8-1 per cent, with a central value of 0.9 per cent), albeit at the upper end of that interval.

Comparing the policy scenario (DBP) and the trend scenario (Update), the net budget impact (an increase of seven-tenths of a point of GDP in borrowing) has an impact effect (i.e. in the same year of implementation of the measures) of four-tenths of a point of extra growth. This divergence between policy and trend GDP implies a smaller multiplier effect for the budget measures in the first year than that assumed in the Update (which had the same rate of GDP growth, equal to 1 per cent, but a less expansionary budget package). The divergence lies within the range of impact estimates formulated by the PBO forecasters. According to those forecasts, the greater growth in 2017 compared with the trend estimate lies within the interval of 0.2-0.5 percentage points; in the PBO forecast, obtained with the Istat model, the difference is about 0.3 percentage points, with the propagation of the effects to the subsequent period as well (see section 1.2).

The composition of demand assumed in the DBP is broadly similar to that adopted by the PBO panel. However, the contribution of domestic demand is at the upper limit of the PBO panel range. Analysing the individual components of spending, we find no marked divergences between the DBP scenario and that of the PBO forecasters for exports/imports, private consumption and investment (the latter was out of line in the validation exercise for the policy scenario of the Update). Differences do emerge for the assumptions about general government expenditure, which in the DBP forecast is above the upper limit of the range of PBO panel forecasts. It is likely that this disparity also reflects differences compared with the DBP in the assumptions adopted by the PBO forecasters concerning the breakdown of the change in nominal general government expenditure into price and quantity components.

The developments in the GDP deflator assumed in the DBP fall within the range of the PBO panel forecasts. Considering real GDP growth, it follows that (unlike during the verification of the Update policy scenario) growth in nominal GDP is also within the PBO panel forecasting range.

Figure 1.1 – Forecasts in the policy macroeconomic scenario – 2017

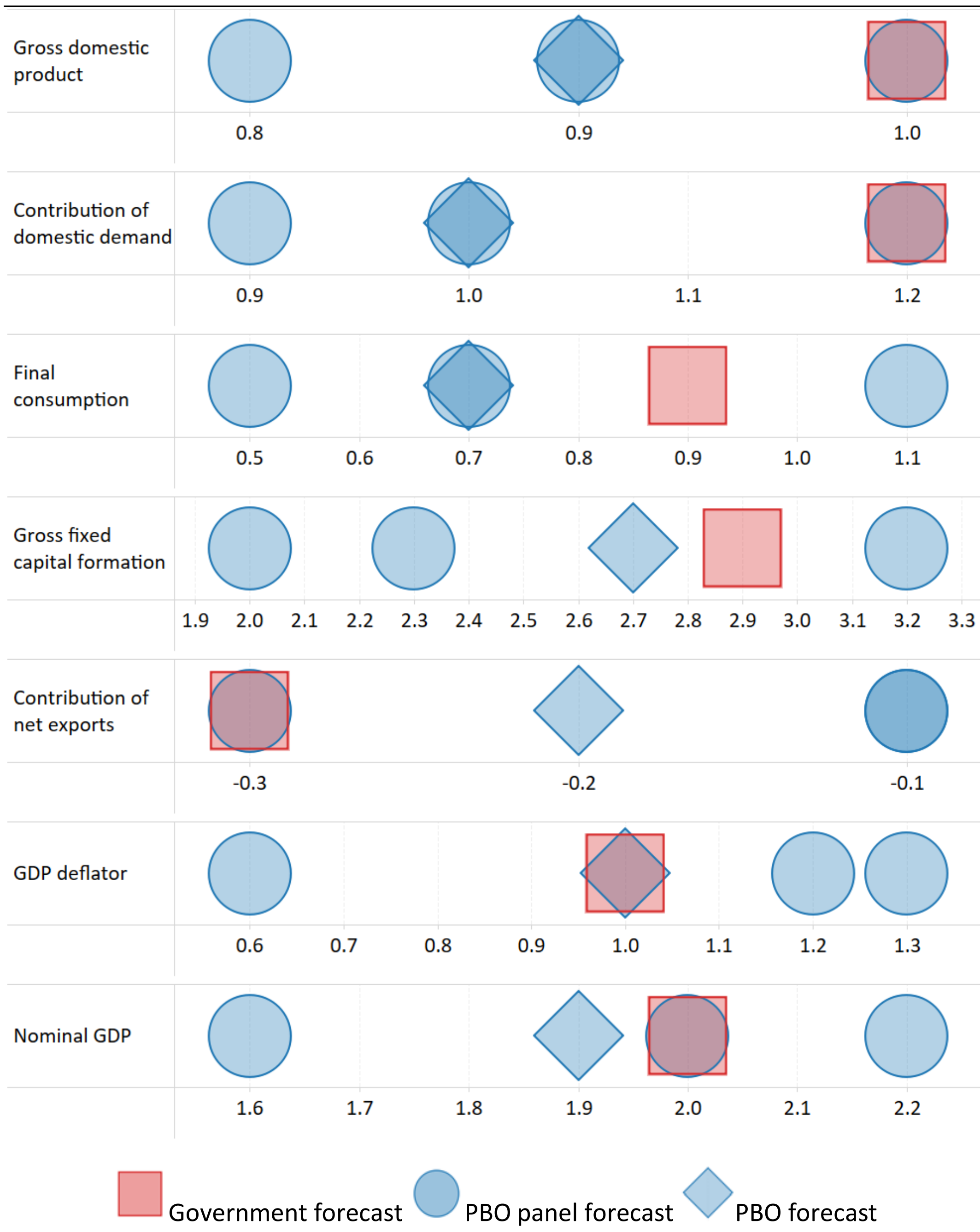
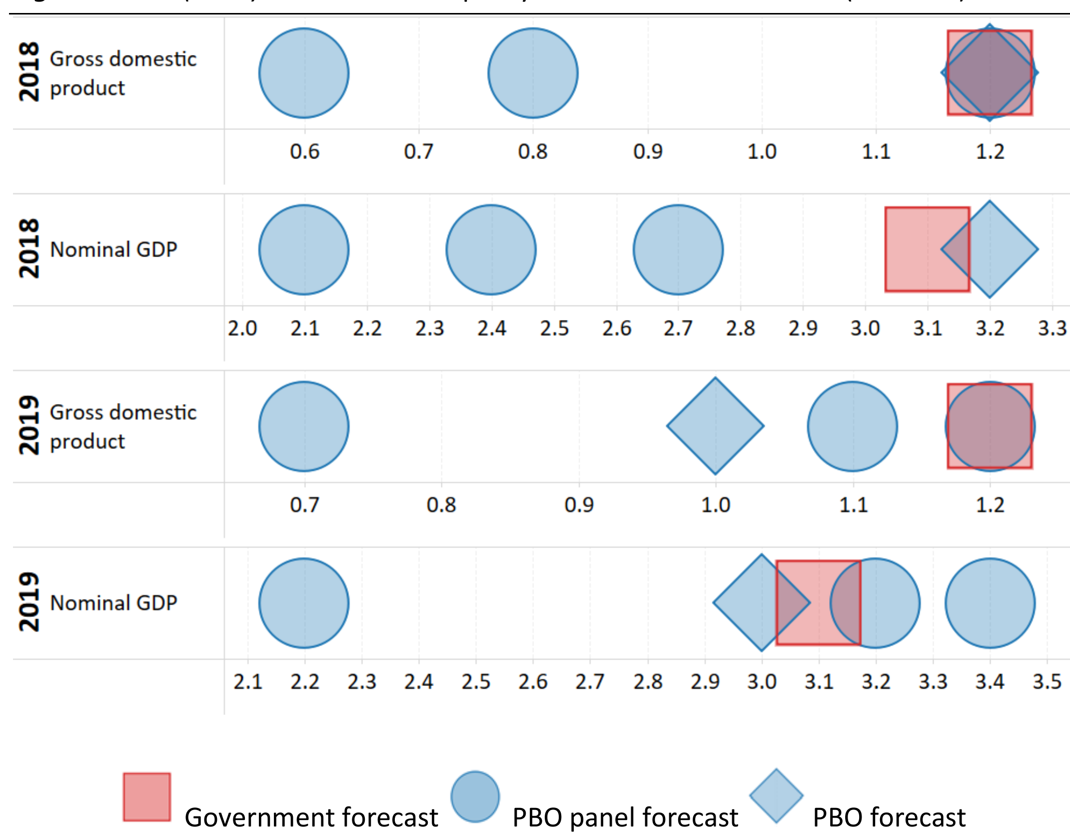


Figure 1.1 – *(cont.)* Forecasts in the policy macroeconomic scenario (2018–19)



In conclusion, on the basis of these analyses, on 17 October the PBO validated the 2016-2017 policy forecasts presented in the DBP, noting however that the projection for real growth in 2017 was at the upper limit of the forecasts of the PBO panel, underscoring the potential risk given the uncertainty the continues to dominate current economic conditions.

Supplementing these assessments, on 9 November the European Commission announced its autumn forecasts. In 2017 Italy is expected to register real growth of 0.9 per cent, driven by domestic demand. The GDP inflator is forecast to rise by 0.9 per cent, with an increase of 1.9 per cent in nominal GDP. This scenario, based on an assumption of net borrowing of 2.4 per cent of GDP, is very similar to the forecasts of the PBO panel and the macroeconomic scenario that the Government presented in the DBP.

1.1.3 The 2018-2019 macroeconomic scenario

The DBP forecasts for 2018 and 2019 put GDP growth at 1.2 per cent in each year. The expansion of economic activity remains driven by the positive contribution of domestic demand. Inflation rises in 2018, reflecting the recovery in economic activity, before stabilising the following year. The GDP deflator increases by 1.9 per cent in 2018 and 1.8

per cent in 2019. As a result of faster real growth and higher inflation, nominal GDP accelerates in 2018 to 3.1 per cent; that rate of growth continues in 2019.

Overall, the DBP growth forecasts for 2018-2019 fall within the range projected by the PBO panel (in the policy scenario of the Update, 2018 was out of line with the panel forecast). However, as in 2017, the rate of growth assumed in the DBP for 2018 and 2019 is close to the upper limit of the range of PBO forecasts (Figure 1.1). It should be noted that the range of forecasts of the PBO panel for the two years is broader than that for 2017, reflecting greater forecasting uncertainty. As a result, the difference between the Government forecast and the central values of the PBO projections is larger (compared with 2017), with the difference of one-tenth of a point in 2017 rising to about two-tenths of a point in 2018 and 2019. With growth in the GDP deflator within the forecasting range, nominal GDP growth lies close to the upper limit of the range of panel forecasts, especially in 2018.

Considering the widening of the difference between the Government forecast for real GDP growth and the central values of the PBO panel forecasts, the potential threats to the growth assumptions in the DBP for 2017 appear even stronger in 2018-2019.

1.2 Estimating the macroeconomic effects of the budget measures

To round out the assessment of the Government's macroeconomic scenario, the PBO conducted an evaluation of the macroeconomic effects of the actual budget measures set out in the Budget Bill and the Tax Decree recently submitted to Parliament, using its own annual econometric model. The impact is quantified on the basis of the trend scenario on an unchanged programme basis and regards the entire 2017-2019 period. In order to facilitate understanding, the measures were classified into seven main areas (for a detailed analysis of the measures in included in the budget package, see section 2.1.2): 1) the deactivation of the VAT safeguard clause for 2017; 2) measures for firms; 3) measures for families; 4) labour market and pension measures; 5) other measures; 6) unchanged policies; 7) financial coverage measures, including the introduction of a new VAT safeguard clause for 2019 (Table 1.2).

Table 1.2 – Impact of the budget measures in the Stability Bill on GDP
(difference in percentage points between policy and trend rates of growth)

	2017	2018	2019
Deactivation VAT increase 2017	0.111	0.134	-0.155
Firms	0.035	0.143	0.070
Families	0.004	0.049	0.005
Labour market and pensions	0.020	0.055	0.029
Other measures	0.154	-0.011	0.023
Unchanged policies	0.007	-0.008	0.006
Financial coverage	-0.036	-0.090	-0.108
of which: activation of VAT increase 2019	*0.000*	*0.000*	*-0.025*
Total	**0.295**	**0.272**	**-0.129**

Source: PBO estimates.

As noted earlier, the budget package provides for the full suspension of the VAT safeguard clause only for 2017. That would add about 0.1 percentage points of GDP growth in 2017 and have an expansionary impact of the same size in 2018 as well. In 2019, the net impact on GDP would be negative (about -0.2 percentage points compared with the trend): the gradual dissipation of the expansionary effect caused by the suspension of the VAT increase in 2017 would be reflected in a deceleration in policy GDP growth, the level of which would return towards that in the trend macroeconomic scenario. The measures for firms would have a small expansionary impact on GDP in 2017 (less than one-tenth of a percentage point), with a larger impact coming in 2018-2019 (about 0.1 percentage points a year). The expansionary impact of the measures for families would be fairly small, amounting to about 0.06 percentage points over the entire 2017-2019 period, with the main effects manifesting themselves in 2018. The labour market and pension measures would have a cumulative expansionary impact on GDP of about 0.1 percentage points, again concentrated mainly in 2018. The other measures (mainly the refinancing of the fund for urgent interventions, the revival of local public investment, resources for migrants and investments in countries of transit and origin of migration flows) would have an overall impact on GDP growth of nearly 0.2 percentage points in 2017 and almost no impact in the following years. Unchanged policies would have only a modest overall impact on GDP. The financial coverage measures, comprising both increased revenue and spending cuts, would slow GDP growth by very little in 2017 and by about 0.1 percentage points in both 2018 and 2019.

Overall, these developments mean that the budget measures would increase GDP by about 0.3 percentage points in 2017 and in 2018. In 2019, they would trim growth by about 0.1 percentage points.

1.3 *Macroeconomic risks*

The validation of the macroeconomic scenario in the DBP was accompanied by a warning about the risks associated with the uncertainties in current economic conditions. The information available in this closing period of 2016 shows an uneven but generally slow continuation of the recovery. The good performance of industry in July-September reflects the strengthening of economic activity in the third quarter after the stagnation in the previous three months. The PBO's forecasts, based on short-term models, put GDP growth in the third quarter at about 0.3 per cent (the PBO forecast before the release on 10 November of the figures for industrial production in September, which were less negative than expected, was around 0.2 per cent; the preliminary Istat estimate for the third quarter is being released in concomitance with the publication of this Report). Growth is expected to slow again in the fourth quarter, when GDP is forecast to expand by just 0.1 per cent. These quarterly forecasts would produce an annual average increase in GDP for 2016, corrected for the number of working days, of 0.8 per cent. The forecast for raw GDP growth (that used in the Government forecasts), i.e. not adjusted for the smaller number of working days in 2016 than in 2015, would be slightly lower (0.74 per cent, compared with the 0.75 per cent, rounded to 0.8 per cent, in the DBP macroeconomic scenario).

The deceleration at the tail-end of the year would provide only a slightly positive boost to growth next year (0.2 per cent), such that achieving growth of 1 per cent in 2017 would require a stronger (and more continuous) average quarterly recovery than that experienced in 2016. Such a development would be possible in view of the assumptions adopted concerning exogenous variables and the stimulus to the economy of the budget measures. Nevertheless, the outlook for next year is primarily burdened by risk factors of international origin, which must be given due consideration in assessing the overall plausibility of the scenario.

The international uncertainty has been heightened by the outcome of the US presidential election on 9 November, which saw the surprise victory of the Republican candidate Donald Trump. The reaction of financial investors produced strong gains in equity markets and drove a rapid rise in US long-term interest rates, partly in expectation of changes in the economic policy mix that the new administration will adopt (expectation of an expansionary fiscal policy, accompanied by a restrictive monetary policy stance).

At the same time, these developments had a spillover impact on interest rates on government securities in European markets, with a widening of the spread on the German benchmark. The spread between the yield on Italian 10-year securities and that on the equivalent German paper rose in just a few days (between 8 and 12 November) by more than 20 basis points to more than 175 basis points, the largest difference since the summer of 2014. Tensions also impacted Spanish securities, but to a lesser extent than Italian government bonds (the spread in Spain grew by 13 basis points). It is clearly too early to determine if the developments in recent days represent an effective change

in the outlook for interest rates or just an increase in volatility induced by the considerable uncertainty over future developments. It is in any event a change in scenario that forecasters will have to deal with in the coming months, verifying the robustness of the assumptions underpinning the macroeconomic scenarios developed prior to the election.

Examining trends in recent weeks, a period which largely preceded the election, the assumptions about international developments adopted by the Government are essentially in line with observed developments with regard to the oil and foreign exchange markets. Oil was only temporarily impacted by the agreement reached by OPEC in September on production cuts. At the start of November, prices again fell below $50 a barrel, while futures prices for 2017 (1-12 November) were not far from the forecast adopted in the Update/DBP scenarios (Table 1.3). Similarly, developments in the foreign exchange market were not dissimilar to the assumptions used in the Government's forecasts, as shown by the forward dollar/euro exchange rates for next year observed in the first two weeks of November. In the days immediately following Trump's election (between 9 and 12 November), forward markets began to reflect expectations of a weaker oil price and a stronger dollar than had characterized previous trading sessions. A significant question mark about the international scenario regards developments in world trade, especially in the light of the new scenario that has emerged since the US election.

The most recent developments (for the January-August period) show virtually stagnant year-on-year growth in international trade (Table 1.4). The key foreign markets for Italian exports have performed better but gains have still been modest (with a year-on-year rise of just over 1 per cent). These trends for the first eight months of 2016 are considerably weaker than the growth assumed for the entire year in both the Government's scenario and in the projections of international forecasters. And the poor performance came despite world economic growth that was essentially in line with expectations, revealing a further decline in the elasticity of trade to world output from the already low levels registered in recent years (Figure 1.2).

Table 1.3 – Oil prices and the dollar/euro exchange rate

	2016	2017
Oil prices		
Update/DBP	46.6	52.5
IMF, October 2016	43.0	50.6
European Commission, November 2016	45.2	54.7
Forward prices (1-12 November)	42.8	49.4
Dollar/euro exchange rate		
Update/DBP	1.119	1.126
European Commission, November 2016	1.111	1.104
Forward rates (1-12 November)	1.112	1.113

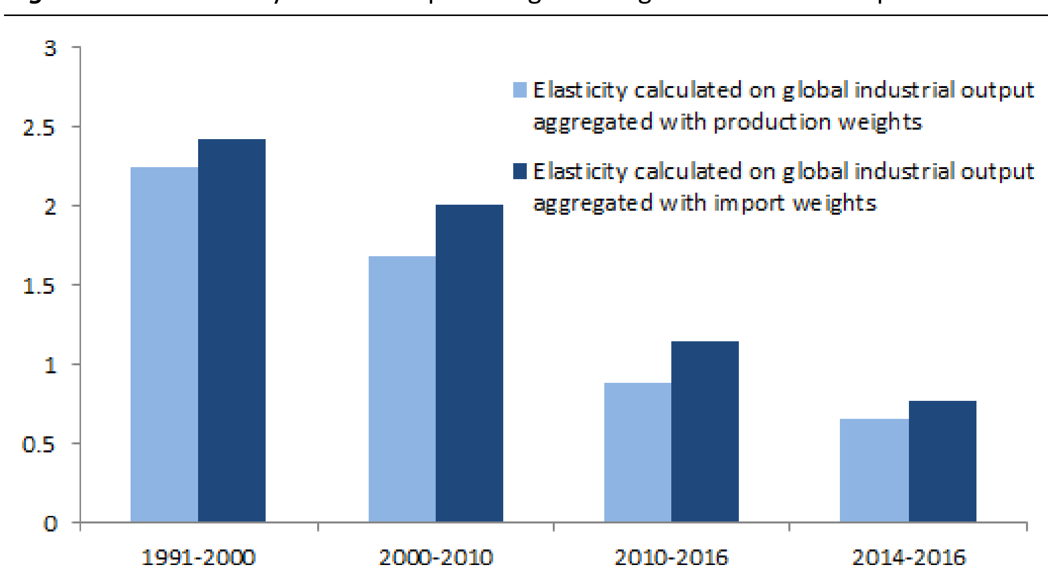
Source: Update September 2016, FMI *World Economic Outlook*, October 2016, European Commission, *Economic Forecast*, November 2016, Thomson Reuters.

Table 1.4 – Developments in world trade
(percentage change on previous year)

	2016				2017		
	CPB January-August	Update/DBP	IMF	EC	Update/DBP	IMF	EC
World trade	0.0	2.1	2.3	1.9	2.6	3.8	3.3
Italy's key markets	1,2(1)	2.6	..	2.8	2.9	..	3.7

Source: Central Planning Bureau, Update, September 2016, FMI *World Economic Outlook*, October 2016, European Commission, *Economic Forecast*, November 2016.
(1) PBO based on CPB data.

Figure 1.2 – Elasticity of world imports of goods to global industrial output



This decline appears to reflect more than just cyclical changes in trade or variations in its geographical composition, but is also structural in nature. Possible factors contributing to this development include a decline in the international fragmentation of production processes after a possible excess of offshoring in recent years, the attenuation of the effects of technological progress in transportation (centring on so-called containerisation) in recent decades, the waning of the impulse of past episodes of trade liberalisation and the emergence of more or less explicit protectionist tendencies in some economies. The outcome of the US election could strengthen this trend looking forward. All of this points to a risk of a non-transient weakening of trade growth in response to a given rate of growth in world trade, one which could continue in the coming years and which could be larger than currently assumed by most forecasters in formulating their projections.

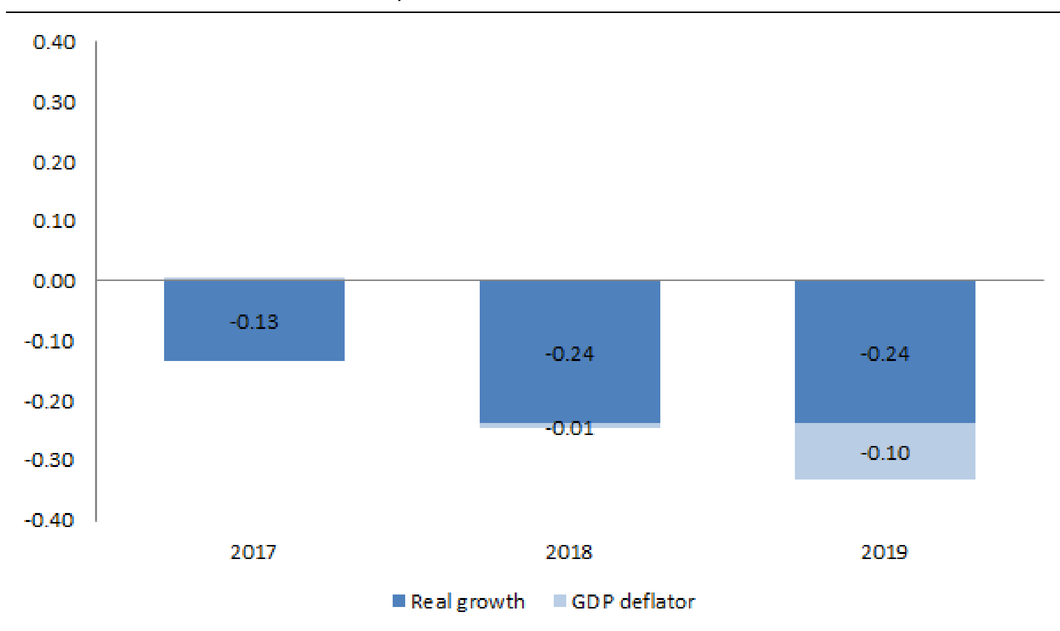
This possibility was accounted for in the simulation prepared on the occasion of the hearing on the Update, which we refer to briefly, concerning the effects on the Italian

economy of structurally weaker growth in global demand. Figure 1.3 reports the impact on real growth, inflation (measured by the GDP deflator) and nominal GDP growth of a one percentage point decrease in the pace of world trade growth in each year of the 2017-2019 period compared with the growth assumed in the Update (which forecasts increases of 2.6 per cent in 2017, 3.5 per cent in 2018 and 4.1 per cent in 2019).

The weakening of world trade growth would depress real growth by reducing foreign demand for Italian goods and services, especially in 2018-2019. There would also be an impact on price developments, as the slower expansion of world trade would lead to a decline in the prices of exports and, given the economic slowdown, cause a gradual decline in the deflators of the components of domestic demand. This would lower the GDP deflator, with the slowdown becoming more pronounced in the final year. Slower real growth and lower inflation would cause nominal GDP to grow more slowly than assumed by the Government in each year of the forecasting period (-0.1 points compared with the benchmark scenario in 2017, -0.25 points in 2018 and -0.3 points in 2019).

Figure 1.3 – Impact on nominal GDP growth in Italy of a 1 per cent reduction each year in the pace of world trade growth

(differences in percentage points compared with the growth rates in the benchmark scenario)



2. THE PUBLIC FINANCES

Compared with the trend developments in the public finances, the measures in the 2017 Budget Bill (supplemented by Decree Law 193/2016) increase borrowing by 0.7 points of GDP in 2017, 0.4 points in 2018 and 0.2 points in 2019.

For 2017, easily the largest measure is the cancellation of the increase in VAT rates and excise duties (the so-called "safeguard clauses"), which amounts to 0.9 per cent of GDP (€15.4 billion). Taken together, the other measures will therefore produce a reduction in borrowing of 0.2 points of GDP, or about €7.3 billion in higher net expenditure and €10.6 billion in higher net revenue. On the expenditure side, the increases involve public-sector employment (€1.5 billion), local government (€1.7 billion, of which around €0.7 billion in capital expenditure), pensions (€1.2 billion), subsidies to households (€0.6 billion), earthquake relief (€0.6 billion) and public investment (€0.6 billion); overall the increase in capital expenditure amounts to around €2 billion. On the revenue side, for 2017 the most important permanent measure is the revision of the aid for economic growth mechanism (as part of corporate income taxes) generating revenue of €1.7 billion. According to official forecasts, the quarterly reporting of VAT data is expected to have a permanent effect, amounting to €1.3 billion in 2017. Other measures essentially have one-off effects and account for about half of the increase in net revenue: tax arrears relief for 2000-2015 (€2 billion), enhanced VAT collection procedures (€0.7 billion), extension of the voluntary disclosure programme (€1.6 billion) and the auction of telecommunications frequency licenses (€2 billion). Cost cutting and tax relief measures contribute relatively modest amounts. It should be noted that the trend scenario incorporates the reduction in corporate income tax rates entering into force in 2017 as called for in last year's Stability Act.

The scenario for 2018 and 2019 reflects the retention of the increase in VAT rates in 2018 and a further increase of 0.9 points in the standard rate in 2019. Together, these measures should yield revenue of €19.6 billion in 2018 and €23.3 billion in 2019, equal to 1.1 and 1.3 per cent of GDP respectively. The budget correction for 2018 includes an increase in net revenue of about €5 billion and higher net expenditure of €11.5 billion; for 2019 there are upwards corrections of €5.4 billion in net revenue and €8.2 billion in net expenditure. On the expenditure side, the main increases are associated with the increasing effects of the measures mentioned above for 2017; of note is the increase in capital expenditure of €5.8 billion in 2018 and €3.6 billion in 2019. As to the net reduction in expenditure, the most important decrease concerns the healthcare system, with cuts of about €1 billion in 2018 and €3 billion in 2019. On the revenue side, major tax cutting measures will be implemented as from 2018, including the introduction of a new income tax for entrepreneurs (IRI) (€2 billion in 2018 and €1.2 billion in 2019), the increase in the permissible deductibility of depreciation and leasing fees for capital equipment (€1.1 billion and €1.9 billion in the two years), and the extension of the tax credit for home eco works and renovations (€0.7 billion and €1.5 billion). The increase in

net revenue is the product of measures introduced for 2017, with a balance between permanent and temporary measures. For 2019, the elimination of the temporary measures is offset by the further increase in the ordinary VAT rate mentioned earlier, generating additional revenue of €3.7 billion.

Overall, the impact of the measures on the public finances is not without risk. Not so much because of the increase in deficit capital spending, given the non-permanent nature of these expenditure and the effects they could have on economic growth, but rather because of the creation of permanent commitments for current expenditure (especially for pensions and public-sector employment) only partially offset by permanent and certain revenue flows. In particular, retaining the increase in the VAT rate and, indeed, raising it further in 2019 in order to ensure the public finances remain sound makes it difficult to discern the medium-t81erm budgetary planning objectives. For the second consecutive year, the most significant budget measure is the cancellation of the increase in VAT rates for the subsequent year. Assuming the Government intends to deactivate the clause again in the following years, the same scenario seems destined to be repeated in future budgets.

The budget approval session under way marks the first application of the changes to the public accounting and finance law introduced in 2016 to make it consistent with the 2012 reform of Article 81 of the Constitution and the consequent implementing provisions contained in the law establishing the principle of budget balance. The most significant changes relate to the budget planning cycle calendar, the information provided in the Update to the EFD and the new format for the Budget Act since it now incorporates the content of the former Stability Act, thereby unifying in a single instrument the entire budget package for the relevant three-year period.

2.1 The public finances in 2016, the policy scenario and the composition of the budget measures

2.1.1 The public finances in 2016 and the policy scenario for the subsequent years

As in 2015, the improvement in net borrowing in 2016 is attributable to more favourable developments in interest expenditure.

For the current year, the Government forecasts a reduction in the deficit from the 2.6 per cent of GDP registered in 2015 to 2.4 per cent (slightly above the 2.3 per cent indicated in the Economic and Financial Document (EFD)) and an analogous decrease in interest expenditure, from 4.2 to 4 per cent. The primary surplus remains stable at 1.5 per cent of GDP, reflecting a decrease of about 0.8 points in outlays net of interest (from 46.2 to 45.5 per cent of GDP) and in revenue (from 47.8 to 47.0 per cent). The tax burden falls from 43.4 per cent to 42.6 per cent. The reduction in primary expenditure is

essentially attributable to that in capital expenditure, equal to 0.6 per cent of GDP, largely associated with the contraction in other expenditure owing to the elimination of a number of significant items that characterized 2015.

More specifically, these refer to the payment in arrears of cancelled pension adjustments, those for grants in arrears to Ferrovie dello Stato (the State Railways), and finally those incurred by the National Resolution Fund to cover the losses of the banks under special administration (later revised upward by Istat on 23 September). With regard to capital expenditure, investment in nominal terms is expected to grow slightly (although remaining a constant 2.2 per cent of GDP); indications from the quarterly general government accounts published by Istat on 3 October, point to a reduction of 1.8 per cent in the first six months of the year. Current primary outlays are expected to decline from 42.1 per cent to 42 per cent of GDP, thanks essentially to the stability expected in the official forecasts for nominal intermediate consumption. However, again for the first half of the year, Istat's accounts indicate growth of 4.1 per cent in intermediate consumption proper, which represents about two thirds of all intermediate consumption.

On the revenue side, direct taxes reflect favourable developments in the main taxes, in particular as regards self-assessment and withholding taxes, while other separate taxation has been reduced. Indirect taxes have decreased owing to public finance measures for 2016 relating to the municipal services tax (TASI) and municipal property tax (IMU) and to the effects of the measures for 2015 concerning the regional business tax (IRAP). More specifically, IRAP registered a much more marked reduction this year than last, having been substantially "discharged" on balances collected in 2016 (and not on advances paid in 2015) owing to the 2015 Stability Act provisions concerning the deduction of labour costs from taxable income. Direct and indirect tax revenue could be more substantial than expected. Capital taxes reflect revenue deriving from the voluntary disclosure programme, in part postponed to 2017 from when initially expected because of administrative problems encountered with collections. Despite contribution relief measures, social contributions have increased, as underscored by monitoring performance during the year.

As to the 2017-2019 policy scenario, the DBP partially revised the information set out in the Update to the EFD. The deficit for 2017 was raised from 2 to 2.3 per cent of GDP, using three-quarters of the additional margin requested in the report attached to the Update (up to 0.4 percentage points of GDP) and authorized by Parliament with the Resolution of 12 October (Table 2.1).

For the subsequent years the deficit targets set out in the Update, equal to 1.2 per cent in 2018 and 0.2 per cent in 2019, have been maintained. The year 2019 is also when the medium-term objective (MTO) is scheduled to be achieved; for Italy the MTO is to achieve structural budget balance (i.e. balance net of cyclical and one-off components). Box 2.1 compares the structural balance targets of the DBP with the autumn forecasts recently published by the European Commission.

Table 2.1 – Public finance indicators: comparison between the 2016 EFD, the Update to the 2016 EFD and the 2017 DBP (1)
(percentage of GDP – + sign = improvement in balance)

	2016 EFD					2016 Update					2017 DBP			
	2015	2016	2017	2018	2019	2015	2016	2017	2018	2019	2016	2017	2018	2019
Trend net borrowing (a)	**-2.6**	**-2.3**	**-1.4**	**-0.3**	**0.4**	**-2.6**	**-2.4**	**-1.6**	**-0.8**	**0.0**	**-2.4**	**-1.6**	**-0.8**	**0.0**
Change (a')		*0.3*	*0.9*	*1.1*	*0.7*		*0.2*	*0.8*	*0.8*	*0.8*	*0.2*	*0.8*	*0.8*	*0.8*
Trend one-off measures	-0.1	0.1	0.0	0.0	0.0	-0.1	0.1	0.0	0.0	0.0	0.1	0.0	0.0	0.0
New measures (b)			**-0.4**	**-0.6**	**-0.3**			**-0.4**	**-0.4**	**-0.2**		**-0.7**	**-0.4**	**-0.2**
Policy net borrowing (c=a+b)	**-2.6**	**-2.3**	**-1.8**	**-0.9**	**0.1**	**-2.6**	**-2.4**	**-2.0**	**-1.2**	**-0.2**	**-2.4**	**-2.3**	**-1.2**	**-0.2**
Change (c')	*0.4*	*0.3*	*0.5*	*0.9*	*1.0*		*0.2*	*0.4*	*0.8*	*1.0*	*0.2*	*0.1*	*1.1*	*1.0*
Cyclical component of policy budget balance (d)	-1.9	-1.2	-0.6	-0.1	0.4	-1.9	-1.3	-0.9	-0.4	0.0	-1.3	-0.9	-0.4	0.0
Policy net borrowing adjusted for cycle (e=c-d)	-0.7	-1.1	-1.2	-0.9	-0.3	-0.8	-1.1	-1.1	-0.8	-0.2	-1.1	-1.4	-0.8	-0.3
Policy one-off measures (f)	-0.1	0.1	0.0	0.0	0.0	-0.1	0.1	0.1	-0.1	-0.1	0.1	0.2	-0.1	-0.1
Policy structural balance (g=e-f)	**-0.6**	**-1.2**	**-1.1**	**-0.8**	**-0.2**	**-0.7**	**-1.2**	**-1.2**	**-0.7**	**-0.2**	**-1.2**	**-1.6**	**-0.7**	**-0.2**
Change (g')	*0.2*	*-0.7*	*0.1*	*0.3*	*0.6*	*0.2*	*-0.5*	*0.0*	*0.5*	*0.6*		*-0.4*	*0.9*	*0.5*
Public debt (h)	**132.7**	**132.4**	**130.9**	**128.0**	**123.8**	**132.3**	**132.8**	**132.5**	**130.1**	**126.6**	**132.8**	**132.6**	**130.1**	**126.7**
Change (h')	*0.2*	*-0.3*	*-1.5*	*-2.9*	*-4.2*	*0.4*	*0.5*	*-0.3*	*-2.3*	*-3.5*	*0.5*	*-0.3*	*-2.5*	*-3.4*

(1) Totals may not match due to rounding of decimals.

With respect to public debt, raising the 2017 deficit by 0.3 per cent of GDP does not imply a corresponding deterioration in the debt/GDP ratio. This is attributable in part to the more favourable developments in nominal growth compared with the forecast in the Update and in part to a reduction in the impact of the stock-flow adjustment. The reduction in this ratio is confirmed starting from next year, when the Government expects to reach 132.6 per cent (132.5 per cent in the Update) compared with an expected 132.8 per cent for 2016.

The debt/GDP ratio should then fall at a faster pace until it hits 126.7 per cent in 2019, for a total reduction of 5.6 percentage points of GDP compared with 2015. The ratio is expected to decline as a result of the privatisation programme – planned for 0.5 per cent of GDP per year in 2017-2018 and 0.3 per cent in 2019 – and the snowball effect (i.e. the effect associated with the accumulation of debt in the preceding years), which decreases over time and becomes favourable starting in 2018, thanks in particular to forecasts of nominal GDP growth of more than 3 per cent.

Box 2.1 – Brief comparison of the public finance forecasts in the DBP and those of the European Commission

This box presents a brief comparison of the public finance forecasts set out in the DBP and the more recent ones published by the European Commission in its 2016 Autumn Forecast. The results are shown in Table R2.1.1.

First, it is interesting to note that, during the 2016-2017 period, with very similar net borrowing, the structural net borrowing forecast by the European Commission is less favourable than that of the DBP. This is due to the different output gap estimates used by the Government and by the European Commission to calculate the cyclical component of the budget. In fact, since the absolute value of the output gap in the DBP is higher than that of the Commission, the cyclical component of the budget to be subtracted from actual net borrowing to produce the structural net borrowing is larger.

Shifting the focus from the levels to the changes in the structural balance, which are more easily compared because they are only minimally affected by the different output gap estimates, the deterioration forecast by the European Commission in 2017 is about 0.5 percentage points, higher than the Government's 0.4 points. Looking at the components, we can see that this reflects a less favourable improvement in interest expenditure for 2017 in the forecasts of European Commission compared with the DBP. By contrast, the primary structural balance is forecast to deteriorate to the same extent by both the DBP and the European Commission (0.7 percentage points) although they use different mixes of revenue and primary expenditure adjusted for cyclical effects.

As for 2018, the European Commission's public finance forecasts differ significantly from those of the DBP. In fact, the European Commission bases its forecasts on the assumption that policies will remain the same rather than on a current legislation basis; therefore some of the measures contained in the budget package were not taken into account. More specifically, the main reason for the differences between the two forecasts is the increase in indirect taxes projected on a current legislation basis but not taken into account under the Commission's unchanged policy approach since the Government has frequently included these increases in its policy scenario only to revoke them later.

As a consequence, the net borrowing forecast by the European Commission is equal to 2.5 per cent of GDP, 1.3 percentage points worse than that in the DBP. In structural terms, the European Commission expects a deterioration of 0.2 percentage points in the balance in 2018 compared with 2017, whereas the DBP forecasts a 0.8 point improvement. This is entirely due to the different forecasts of the primary balance adjusted for cyclical effects, for which the European Commission projects a deterioration of 0.7 percentage points, while the DBP expects an improvement of 0.5 points. The deterioration forecast by the European Commission is due to revenue adjusted for cyclical effects, which is expected to fall by 0.3 percentage points, and to expenditure adjusted for cyclical effects, which is expected to rise by 0.4 percentage points over 2017.

Table R2.1.1 – Public finance objectives of the DBP and Commission forecasts (1)
(percentage points)

	2016		2017		2018	
	DBP	COM	DBP	COM	DBP	COM
Actual net borrowing	-2.4	-2.4	-2.3	-2.4	-1.2	-2.5
Structural net borrowing	-1.2	-1.6	-1.6	-2.2	-0.7	-2.4
Change in structural net borrowing			-0.4	-0.5	0.9	-0.2
of which: change in interest expenditure			*-0.3*	*-0.2*	*-0.1*	*-0.2*
Change in primary structural balance			*-0.7*	*-0.7*	*0.8*	*-0.4*
of which: one-off changes			*0.1*	*0.1*	*-0.3*	*-0.3*
Change in cyclically-adjusted primary balance			*-0.6*	*-0.6*	*0.5*	*-0.7*
of which: change in cyclically-adjusted revenue			*-0.3*	*-0.5*		*-0.3*
change in cyclically-adjusted primary expenditure			*0.3*	*0.1*		*0.4*

Source: Based on data from the 2017 DBP and the European Commission's *Autumn Forecasts* of November 2015.
(1) Totals may not match due to rounding of decimals.

2.1.2 The budget measures: Decree Law 193/2016 and the 2017 Budget Bill

The changes in the budget framework were set out in the budget measures contained in the Budget Bill recently presented to Parliament and in the Tax Decree (Decree Law 193/2016) in October.

In the presentation of the budget measures, in order to provide a reading consistent with the official framework, no consideration will be given to the different accounting treatment that, based on national accounting standards (ESA 2010), should be applied to telecommunications frequency licenses, which has been included among the increase in revenue instead of under the decrease in capital expenditure.

The net impact of the two measures is a deterioration in the general government budget balance compared with the current legislation basis of around €12 billion in 2017 (0.7 per cent of GDP), €6.6 billion in 2018 (0.4 per cent of GDP) and €2.8 billion in 2019 (0.2 per cent of GDP). Excluding neutralization of the safeguard clauses, the budget package improves the balance for 2017. With the acquisition of resources of €17.1 billion next year and €19.8 and €23.7 billion in the subsequent two years, uses are expected to amount to €29.1 billion in 2017, €26.4 billion in 2018 and €26.5 billion in 2019.[1] Around half of the value of the measures for next year (about €15.4 billion) will derive from the deactivation of the safeguard clauses. This latter move enables a reduction in net revenue for 2017 of around €5 billion, followed by increases in the same amount in the subsequent two years, with the change for 2019 in particular relating in large part (around €3.7 billion) to a new VAT measure. Net revenue, excluding the safeguard clauses, shows an increase of €10.6 billion in 2017, which falls to €5.1 billion in 2018 and €1.7 billion in 2019. Net expenditure rises at an increasing rate in the two years (from €7.3 to €11.5 billion) before slowing in 2019 (to €8.2 billion), due particularly to the significant reduction in capital expenditure planned for that year (Table 2.2).

On the uses side, the measures increase spending for the entire three-year period, especially current expenditure, while – net of the sterilization of the safeguard clause – the measures to reduce revenue are concentrated in 2018-2019. Vice-versa, with respect to the resources to cover commitments, the corrective measures mainly address revenue, with a considerable number of one-off revenue measures in the first year; expenditure savings are more concentrated in the final year, particularly with respect to capital expenditure.

[1] The resources and the uses are considered net of the Fund for Structural Economic Policy Interventions (FISPE).

Table 2.2 – Decree Law 193/2016 and the 2017 Budget Bill: budget measures for 2017-19

(millions of euros and percentage of GDP)

	2017	2018	2019
USES	**29,067**	**26,356**	**26,460**
As a % of GDP	*1.7*	*1.5*	*1.5*
Increases in expenditure	12,423	15,995	17,001
Current	*9,882*	*10,021*	*9,863*
Capital	*2,541*	*5,974*	*7,138*
Decreases in revenue	-16,644	-10,361	-9,460
Deactivation of safeguard clauses	*-15,353*	*-199*	*0*
RESOURCES	**17,057**	**19,758**	**23,666**
As a % of GDP	*1.0*	*1.1*	*1.3*
Increases in revenue (1)	11,901	15,252	14,844
New safeguard clause	*0*	*0*	*3,679*
Decreases in expenditure	-5,156	-4,505	-8,822
Current	*-4,610*	*-4,337*	*-5,235*
Capital	*-546*	*-168*	*-3,587*
NET REVENUE (1)	**-4,744**	**4,891**	**5,384**
NET EXPENDITURE	**7,267**	**11,490**	**8,178**
Current	*5,272*	*5,684*	*4,628*
Capital	*1,995*	*5,806*	*3,550*
NET BORROWING (2)	**-12,010**	**-6,599**	**-2,794**
As a % of GDP	*-0.7*	*-0.4*	*-0.2*

Source: based on data from the financial schedules attached to the 2017 Budget Bill and Decree Law 193/2016.
(1) The table takes account of the effects of reporting the telecommunications frequency licenses among the increases in revenue, since in the schedule summarizing the financial effects of the 2017 Budget Bill (AC 4127) it is classified under non-tax revenue for net borrowing purposes as well, while pursuant to ESA 2010 it should be included under expenditure as a reduction in capital expenditure. – (2) A positive (negative) sign indicates an improvement (deterioration) in the balance.

The analysis of the budget measures requires a comprehensive reading of a set of measures found in various acts. First, consideration must be given to the measures and corresponding financial effects contained in both the Tax Decree and in the Budget Bill (both Section I and Section II), as well as any resources “transferred” from one measure to the other through the increase (in the Tax Decree) and subsequent use (in the Budget Bill), for coverage purposes, of the Fund for Structural Economic Policy Intervention (FISPE). Furthermore, we find the definition of measures provided for in the decree and quantified in the bill, as in the case of the extension of the voluntary disclosure programme. As explained in Section 2.4, the reading of the budget measures would be helped by more integrated information schedules. The practice of displaying the financial effects of the Budget Bill, including those on the macroeconomic feedback from the budget measures, in a specific item in the schedule summarizing the financial effects of the Budget Bill is to be welcomed. It should be noted that macroeconomic feedback could arise (and therefore be recorded in the schedules) only if the determination of its effects can be credibly grounded in solid information and methodology enabling the

production of sufficiently reliable forecasts. The adoption of this methodology of highlighting the feedback effects means that the impact on tax variables must also be reported in the case of deficit-containment budget packages, thereby requiring activation of additional resources for coverage.

Returning to the discussion of the budget measures, on the uses side it is possible to identify the various areas of intervention of the main measures (Tables 2.3 for an overview and 2.4 for a breakdown).

First, the budget calls for the full deactivation of the VAT safeguard clause for 2017, as well as the abrogation of the excise tax increase for 2017-18 provided for in the 2014 Stability Act. For the following years, the VAT and excise tax increases set out in existing clauses are to be maintained, with a further increase of 0.9 percentage points in the 25 per cent VAT rate as from 2019 (for a summary of the abrogated safeguard clauses, both deactivated and active, see Table 2.5).

Measures benefitting *firms* constitute a significant portion of the budget. The main measures include: 1) the deferment and extension of the increase in the deductibility of depreciation on investments in machinery and equipment and on new high-tech assets; 2) the introduction of a new income tax for entrepreneurs (IRI) in order to eliminate tax distortions created by the legal form of firms; 3) changes in the VAT regime for groups of companies; 4) the extension and strengthening of the tax credit for investment in research and development.

It should be noted that the 2016 Stability Act called for reducing the corporate income tax (IRES) rate from 27.5 to 24 per cent beginning in 2017.

Numerous measures have been taken in the *pension sector*: 1) increasing and extending the additional “14th payment” each year to low-income pensioners; 2) expanding the no-tax area for pensioners; 3) the consolidation of contributions without additional charges for workers who have accrued rights in more than one pension contribution scheme; 4) facilitating qualification for pensions for early career starters and for those engaged in physically demanding work; 5) the early retirement loan programme (APE); 6) the early retirement programme for hardship categories (APE sociale); and 7) introducing the eighth safeguard mechanism for former workers who are no longer eligible for a pension following pension reform.

Measures in support of the *labour market* include: 1) tax relief for productivity bonuses and 2) a reduction in the contribution rate for the self-employed.

Table 2.3 – Impact of the 2017 Budget Bill and Decree Law 193/2016 on the general government accounts
(millions of euros)

	2017	2018	2019
NET REVENUE	**-4,744**	**4,891**	**5,384**
Safeguard clauses	-15,353	-199	3,691
NET REVENUE NET OF SAFEGUARD CLAUSES	**10,609**	**5,090**	**1,693**
Measures in 2017 Budget Bill			
Change in AEG (aid for economic growth) - reduction of return from 4.75% in 2016 to 2.3% in 2017 and 2.7% as from 2018	1,706	1,527	1,423
IRI - enters force for 2017 tax year - 24% rate	0	-1,986	-1,235
Cash accounting taxpayers in simplified accounting system	0	1,331	-553
Increase in deductible depreciation and lease payments on new capital equipment	0	-1,131	-1,923
Extension of redetermination of purchase value of land and equity investments	320	160	160
Change in VAT rules for changes in taxable amount or tax	340	340	340
Change in energy efficiency and building renovations tax credit	29	-740	-1,547
Tax relief for productivity bonuses	-209	-390	-382
No tax area retirees younger than 75	-213	-247	-246
Suspension of increase in surcharge on passenger boarding fees	-184	-184	0
State participation in Solidarity Fund for retraining of bank personnel	-174	-224	-139
Extension of voluntary disclosure programme	1,600	0	0
Revision of telecommunications frequency licenses (1)	2,010	0	0
Other measures (balance)	775	271	-158
Feedback effects of increased revenue	350	1,050	2,200
Measures in Decree Law 193/2016			
Facilitated settlement of tax arrears for 2000-2015	2,000	400	300
Quarterly reporting of invoices and VAT settlement data	2,110	4,230	2,770
Strengthening of tax collection efforts	0	483	483
Other measures	150	200	200
NET EXPENDITURE	**7,267**	**11,490**	**8,178**
Measures in 2017 Budget Bill			
Pension measures	1,192	2,101	2,637
Government personnel bargaining agreement	1,480	1,930	1,930
Fund for enhancing school independence	140	400	400
Fund for financing measures for local authorities	970	970	970
Budget balance of local authorities - inclusion of restricted long-term fund	304	296	302
Use of surpluses and debt for investments under national solidarity pacts - regions and other local authorities	420	746	706
Healthcare - Fund from regional participation in purchasing of innovative pharmaceuticals	1,000	1,000	1,000
Redetermination of financing of NHS funding requirement	-1,063	-1,998	-3,988
Measures for families	600	716	715
Earthquake emergency - tax credit for private reconstruction and grants for public reconstruction	600	800	950
Fund for extraordinary measures revival of dialogue with African countries on migration routes	200	0	0
Extension and expansion of tax credit for R&D	0	727	727
Fund to be allocated for revival of investment and development of the country	629	1,968	3,500
Refinancing of fund for urgent interventions	300	300	300
Refinancing and reprogramming - second section	2,324	1,196	934
Defunding - second section	-2,671	-1,573	-1,082
Reprogramming - second section	0	0	-3,393
Other measures (balance)	842	1,267	1,571
Measures in Decree Law 193/2016			
Financing of State Railways investments - Contribution to RFI programme contract	0	400	0
Tax credit for technology upgrade for VAT reporting	0	245	0
NET BORROWING (2)	**-12,010**	**-6,599**	**-2,794**

Source: based on data from the financial schedules attached to the 2017 Budget Bill and Decree Law 193/2016.
(1) In the schedule summarizing the financial effects of the 2017 Budget Bill (AC 4127) the item is classified under non-tax revenue for net borrowing purposes, while pursuant to ESA 2010 it should be included under expenditure as a reduction in capital expenditure. – (2) A positive (negative) sign indicates an improvement (deterioration) in the balance.

Table 2.4 – Impact of the 2017 Budget Bill and Decree Law 193/2016 on the general government accounts
(millions of euros)

	2017	2018	2019
USES (1)	**29,067**	**26,356**	**26,460**
as a percentage of GDP	*1.7*	*1.5*	*1.5*
Increased expenditure	**12,423**	**15,995**	**17,001**
Increases in current expenditure	***9,882***	***10,021***	***9,863***
Fund for general government contracts	1,480	1,930	1,930
Fund for enhancing school independence	140	400	400
Fund for financing measures for local authorities	970	970	970
Extra pension payment for retirees	800	800	800
Fund from regional participation in purchasing of innovative pharmaceuticals	500	500	500
Fund from regional participation in purchasing of innovative oncological pharmaceuticals	500	500	500
Early retirement for early career starters	360	550	570
Early retirement for hardship categories	300	609	647
Consolidation of pension contributions	87	132	164
Early retirement for people in physically demanding occupations - pension costs	85	86	125
Refinancing of Fund for additional safeguard measures for workers no longer eligible for pension after pension reform	642	406	107
Costs of eighth safeguard measure	134	295	346
Childbearing bonus	392	392	392
Day-care allowance	144	250	300
Refinancing of Fund for urgent interventions	300	300	300
Fund for extraordinary measures revival of dialogue with African countries on migration routes	200	0	0
Special fund for current expenditure	100	200	200
Second section refinancing (of which: non-self-sufficient €50 million as from 2017 and poverty €500 million as from 2018)	2,054	1,037	932
Other measures	695	665	681
Increases in capital expenditure	***2,541***	***5,974***	***7,138***
Fund to be allocated for revival of investment and development of the country	629	1,968	3,500
Extension and expansion of tax credit for R&D	0	727	727
Earthquake emergency - tax credit for private reconstruction	400	500	600
Earthquake emergency - grants for public reconstruction	200	300	350
Budget balance of local authorities - inclusion of restricted long-term fund	304	296	302
Use of restricted surpluses for investments under national solidarity pacts - local authorities	245	435	405
Use of restricted surpluses for investments under national solidarity pacts - regions	175	311	301
Special capital account expenditure	50	150	200
Refinancing and reprogramming - second section	271	159	2
Financing of State Railways investments - Contribution to RFI programme contract (DL 193/2016)	0	400	0
Tax credit for technology upgrade for VAT reporting (DL 193/2016)	0	245	0
Other measures	268	483	751
Decreased revenue	**-16,644**	**-10,361**	**-9,460**
Elimination of VAT increase for 2017	-15,133	0	0
Elimination of excise tax increase under 2014 Stability Act	-220	-199	0
No tax area retirees younger than 75	-213	-247	-246
Tax relief for productivity bonuses	-209	-390	-382
Suspension of increase in surcharge on passenger boarding fees	-184	-184	0
State participation in Solidarity Fund for retraining of bank personnel	-174	-224	-139
Change in energy efficiency and building renovations tax credit	-138	-1,513	-1,369
Reduction in the contribution rate for the self-employed	-108	-292	-370
Tax credit for accredited private school costs	-79	-82	-83
Tax relief for investments of funds	-10	-79	-93
IRI - enters force for 2017 tax year - 24% rate	0	-5,332	-3,112
Increase in allowable depreciation and lease payments on new capital equipment	0	-1,131	-1,923
Abolition of personal income tax for professional farmers and smallholders	0	-228	-135
Cash accounting taxpayers in simplified accounting system - IRPEF and IRAP	0	0	-553
Group VAT	0	0	-158
Other measures	-157	-358	-598
Tax effects:	-15	-100	-300
Contributions, withholdings and other amounts charged to employers.	-3	-3	-0.1
NET REVENUE	**-4,744**	**4,891**	**5,384**
NET EXPENDITURE	**7,267**	**11,490**	**8,178**
current	*5,272*	*5,684*	*4,628*
capital	*1,995*	*5,806*	*3,550*
NET BORROWING (2)	**-12,010**	**-6,599**	**-2,794**
as a percentage of GDP	*-0.7*	*-0.4*	*-0.2*

Table 2.4 – *(cont.)* Impact of the 2017 Budget Bill and Decree Law 193/2016 on the general government accounts
(millions of euros)

	2017	2018	2019
RESOURCES (1)	**17,057**	**19,758**	**23,666**
as a percentage of GDP	*1.0*	*1.1*	*1.3*
Increased revenue	**11,901**	**15,252**	**14,844**
Revision of telecommunications frequency licenses (3) (with safeguard clause on reduction of appropriations)	2,010	0	0
Change in AEG (aid for economic growth) - reduction of return from 4.75% in 2016 to 2.3% in 2017 and 2.7% as from 2018	1,706	1,527	1,423
Extension of voluntary disclosure programme (with safeguard clause on reduction of expenditure)	1,600	0	0
Change in VAT rules for changes in taxable amount or tax	340	340	340
Extension of redetermination of purchase value of land and equity investments	320	160	160
Measures concerning tax warehouses for energy products	105	105	105
Measures to prevent tax avoidance with regard to tax warehouses	100	100	100
Change in rules governing part-time work in private sector	100	50	0
IRI - enters force for 2017 tax year - 24% rate	0	3,345	1,876
Cash accounting taxpayers in simplified accounting system	0	1,331	0
New VAT increase in 2019	0	0	3,679
Facilitated settlement of tax arrears for 2000-2015 (DL 193/2016)	2,000	400	300
Quarterly VAT reporting (DL 193/2016)	1,130	2,270	2,170
Quarterly VAT reporting (DL 193/2016)	300	600	600
Acceleration of audits for quarterly reporting of VAT settlement data (DL 193/2016)	680	1,360	0
Strengthening of tax collection efforts (DL 193/2016)	0	483	483
Other revenue (DL 193/2016)	150	200	200
Feedback effects - increase in tax revenue	246	704	1,600
Feedback effects - increase in contribution revenue	104	346	600
Other measures	245	88	91
Tax effects:	171	948	222
Energy efficiency and building renovations tax credit	*167*	*845*	*84*
Other	*4*	*104*	*138*
Contributions, withholdings and other amounts charged to employers.	594	895	895
Decreased expenditure	**-5,156**	**-4,505**	**-8,822**
Decrease in current expenditure	***-4,610***	***-4,337***	***-5,235***
Defunding - second section	-2,229	-1,510	-1,017
Redetermination of financing of NHS funding requirement	-1,056	-1,890	-3,666
Redetermination of financing of NHS funding requirement - special-statute regions and autonomous provinces	-7	-108	-322
Savings from redetermination of costs protected from pension reform	-642	-406	-107
Savings from Fund for additional safeguard measures for former workers no longer eligible for pension after reform	-510	-112	0
Reduction in Fund for additional safeguard measures for former workers no longer eligible for pension after reform	-134	-295	-107
Other measures	-32	-17	-17
Decrease in capital expenditure	***-546***	***-168***	***-3,587***
Defunding - second section	-442	-64	-65
Reprogramming - second section	0	0	-3,393
Elimination tax credit for pension institutions	-80	-80	-80
Other measures	-24	-24	-49

Source: Based on data from the financial schedules attached to the 2017 Budget Bill and Decree Law 193/2016.
(1) The uses and resources are considered net of the Fund for Economic Policy Intervention (FISPE). – (2) A positive (negative) sign indicates an improvement (deterioration) in the balance. – (3) In the schedule summarizing the financial effects of the 2017 Budget Bill (AC 4127) the item is classified under non-tax revenue for net borrowing purposes, while pursuant to ESA 2010 it should be included under expenditure as a reduction in capital expenditure.

Table 2.5 – Budget Bill 2017: deactivated and active safeguard clauses

Measure	2017	2018	2019
Safeguard clauses deactivated by the 2017 Budget Bill			
Deactivation of increase in VAT rate from 10% to 13% as from 2017 (Art. 1, para. 718, letter a), SA 2015)	-6,957		
Deactivation of increase in VAT rate from 22% to 24% as from 2017 (Art. 1, para. 718, letter b), SA 2015)	-8,176		
Repeal of increase in excise taxes from 2017 to 2018 (Art. 1, para. 626, SA 2014)	-220	-199	12
Total deactivated clauses	**-15,353**	**-199**	**12**
Safeguard clauses active after 2017 Budget Bill			
Confirmation of existing clauses			
Increase in VAT rate from 10% to 13% as from 2018 (Art. 85, para. 1, letter a)) (1)		6,957	6,957
Increase in VAT rate from 22% to 25% as from 2018 (Art. 85, para. 1, letter b)) (2)		12,264	12,264
Increase in excise tax on fuel as from 2018 (Art. 1, para. 6, letter c), SA 2016)		350	350
New clauses			
Increase in VAT rate from 25% to 25.9% as from 2019 (Art. 85, para. 1, letter b))			3,679
Total increases triggered if alternative measures not found	**0**	**19,571**	**23,250**

Source: Based on data from the technical report attached to the 2017 Budget Bill.
(1) Article 1, paragraph 718, letter a) of LS 2015 called for an increase starting from 2017; the Budget Bill envisages it starting from 2018. – (2) Article 1, paragraph 718, letter b) of LS 2015 envisaged a gradual increase, from 22 to 24 per cent in 2017 and to 25 per cent as from 2018; the Budget Bill calls for a single increase of 3 percentage points starting from 2018.

Other resources are allocated for *families* and the *fight against poverty*. The primary measures envisage: 1) providing subsidies in the event of the birth or adoption of a child, as well as for households in need of help with parenting expenses; 2) funding for day-care facilities; 3) increasing the fund for non-self-sufficient persons (section II); and 4) starting from 2018 increasing appropriations for the fund for the fight against poverty and social exclusion (section II).

In the area of *healthcare*, the most important initiatives regard: 1) subsidies for the purchase of innovative pharmaceuticals and 2) recalculation of the funding needed for the national healthcare system.

Other measures are designed to improve *human capital*: 1) resources for universities (tuition, funding for scholarships and grants, funding for basic research); 2) completion of the school reform for the early childhood education sector; 3) the grant for accredited private schools, with an additional grant for private preschools; 4) funding for the electronic voucher for cultural spending provided to 18-year-olds (section II).

Additional measures seek to revive both national and local *public investment*, while a block of specific measures address the *finances of local government and autonomous and special-statute regions*.

Other resources are allocated for *public-sector employment* for: 1) the resumption of contract renewals; 2) the stabilization of the €80 monthly tax credit ("bonus") for law enforcement personnel; 3) the hiring of new staff.

Other funding is allocated for the *immigration* emergency: 1) for receiving migrants (section II) and 2) for investment in the countries of transit and origin of migrants.

The budget also includes measures for the areas hit by *earthquakes* last August, for public and private reconstruction. Associated programmes include measures for improving the safety of the area, with the extension of tax credits for building renovation, seismic upgrading and energy-efficiency enhancements, for the purchase of furniture and tax credits for hotels.

Finally, funding is allocated for a number of sectors on an unchanged policy basis, as well as tax relief and measures for the culture sector.

The main measures to generate resources to fund these commitments involve combatting tax evasion, reducing current spending and enacting one-off measures (Table 2.3 for an overview and Table 2.4 for a breakdown).

Revenue increases include: 1) a new VAT safeguard clause for 2019; 2) the revision of the aid for economic growth mechanism (AEG) as part of corporate income taxation; 3) the one-off effects of a grant for the change in use of telecommunications frequencies; 4) the recovery of VAT not paid to customs authorities, as well as a package of measures for *combatting tax evasion and enhancing collection*, which mainly include: 1) the introduction of new obligations for the electronic reporting of data and invoices; 2) tax arrears relief measure for 2000-2015; 3) the extension and expansion of the voluntary disclosure programme; and 4) the strengthening of tax collection processes.

Expenditure savings include broad defunding and reprogramming measures (section II), including the review and reprogramming of expenditure by ministries, a reduction in the Fund for urgent interventions and reprogramming of capital expenditure for 2019.

As noted previously, the financial effects of the 2017 Budget Bill include revenue from the feedback effects of the overall expansionary policy, which add to the initial fiscal effects of the individual measures and the contributions, withholdings and other amounts charged to employers deriving from the increase in collections for contributions under personal income tax (IRPEF) and the regional business tax (IRAP) as a result of the rise in income of government workers.

In summary, in 2017 more than 41 per cent of the deactivation of the VAT and excise tax safeguard clauses (about €15.4 billion) and measures in various other sectors (around €14 billion) is made possible by increasing the deficit (€12 billion), with the remaining 59 per cent (€17.1 billion) accounted for by other corrective measures. These corrective measures can basically be divided into three categories of similar size: an increase in

structural revenue (€5.6 billion, 32.7 per cent of resources) from – in addition to the AEG – the expansion of the tax base thanks to the fight against tax evasion and other minor measures; the review and reprogramming of expenditure (about €5.2 billion, equal to 30.4 per cent of resources); and one-off revenue measures (about €6.3 billion, or 36.8 per cent of resources). One-off revenue includes funds raised from: telecommunications frequency licenses,[2] the extension of the voluntary disclosure programme[3] and, presumably, the facilitated settlement of tax arrears, as well as the acceleration of audits of quarterly VAT reports. This €6.3 billion does not include one-off measures with effects that repeat over time, which could finance part of the expenditure, also one-off, allocated for tax credits for private and public reconstruction. During 2018-2019, more substantial interventions, smaller one-off measures and the expansion of the trend budget deficit (although smaller than that in 2017) do not enable the elimination of the VAT and excise tax safeguard clauses and in fact require additional measures in the final year of the planning period, mainly in the form of a new VAT clause and larger corrective measures for spending (specifically, healthcare spending and the reprogramming both investment grants for the State Railways and the EU policies co-financing revolving fund).

In conclusion, the critical elements of the budget include the way, in 2017, the deactivation – temporary – of past safeguard clauses is funded and how structural commitments are funded in part with one-off measures, as in 2016, as well as anti-tax-evasion measures of uncertain amount. For the subsequent two-year period, it relies on trend scenarios that still assume the existence of safeguard clauses and a reduction in interest expenditure. Nor can the budget continue to count on the absence of contract renewals with public-sector employees after their resumption following Constitutional Court ruling 70/2015, which found the ban on collective bargaining for the public sector to be unconstitutional. In addition, the growth underlying the public accounts is exposed to additional risk factors compared with those in the scenarios of other forecasters.

2.2 Analysis of the fiscal stance

The fiscal stance, i.e. the expansionary or restrictive orientation of fiscal policy against the background of the macroeconomic environment, can be analysed by comparing developments in the structural primary balance (the primary balance adjusted for

[2] The Budget Bill contains safeguard mechanisms designed to ensure that the expected resources are raised, with the allocation of provisions that could be subsequently reduced if the results of the measure on frequencies are not achieved in whole or in part.

[3] If extending the mechanism does not produce higher revenue, the shortfall shall be offset by a reduction in the spending of the ministries. In the case of shortfalls that cannot be offset, the Ministry for the Economy and Finance, if there is a threat to the achievement of the public finance objectives, will undertake by 30 September 2017 the consequent legislative initiatives to ensure compliance with Article 81 of the Constitution.

cyclical effects and net of one-off items) and the output gap (the gap between actual and potential GDP).

Figure 2.1 demonstrates how this stance has been modified in the succession of planning documents issued in 2016.

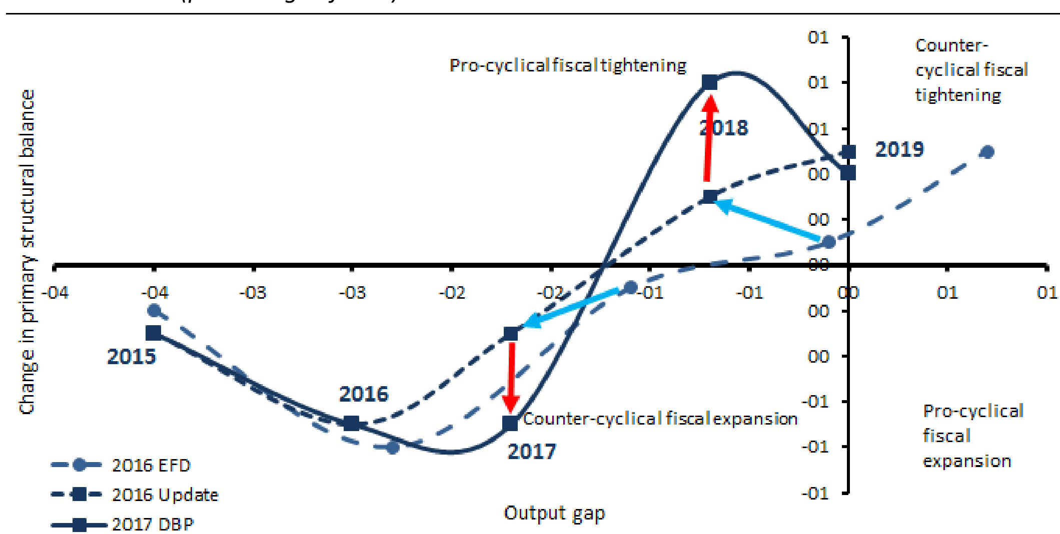
The 2016 EFD was essentially neutral to cyclical developments in 2017 and 2018, when the current adverse phase was expected to continue, albeit in attenuated form. The most substantial part of the fiscal consolidation was postponed to 2019, when an expansionary phase is expected to begin (backloaded consolidation). This time profile for the correction appeared to be designed to avoid suffocating the recovery (which was expected to lead to the gradual closing of the output gap in 2017-2018) in its early stages with a large-scale restrictive policy. The budget policy was therefore only slightly counter-cyclical in the first year and slightly pro-cyclical in the second, given the need to maintain, even with a moderately negative output gap, a path to reducing the deficit so as to reassure the markets of the effectiveness of the objective to achieve budget balance within the forecasting period. The tenor of the correction of the public finances instead became more markedly counter-cyclical in 2019, since the consolidation of the recovery would make it possible to take stronger action on structural developments in the accounts.

The Update to the EFD (blue arrows in Figure 2.1), acknowledging the deterioration in the economic forecasts (represented in the figure as a leftward shift in the curve, with larger negative values for the output gap in 2017-2018 and the disappearance of the positive output gap in 2019) sought to amplify the counter-cyclical nature of the budget measures in 2017, forecasting a larger deterioration in the structural balance than previously expected. The intent to leave unchanged the objective to achieve budget balance within the forecasting period, as required of countries benefitting from flexibility clauses, inevitably compromised the previous neutral or counter-cyclical stance of the adjustment path of the structural accounts:

Compared with the forecasts in the Update to the EFD, the 2017 DBP (red arrows in Figure 2.1) reinforces the expansionary and counter-cyclical stance of fiscal budget policy for 2017 (from -0.3 points in the Update to -0.7 points in the DBP).[4] Starting the subsequent year, the invariance compared with the Update of the adjustment path towards the MTO means that the more expansionary policy of 2017 is correspondingly offset in 2018, with the consequent intensification of pro-cyclical tightening. The backloaded consolidation set out in the EFD is therefore eliminated: the largest step in the adjustment towards structural balance is forecast to occur in 2018, when the output gap will still be negative.

[4] Of the total difference of four-tenths of a point, three-tenths is attributable to the deterioration in the deficit and one-tenth to the increase in one-off revenue measures.

Figure 2.1 – Tenor of fiscal policy with respect to the cycle (fiscal stance) *(percentage of GDP)*



Sources: based on data from the 2016 EFD, the Update to the 2016 EFD and the 2017 DBP.

2.3 *Risk factors for the financial effects of the budget measures*

A general risk factor for the strength of the public accounts is linked to the plausibility of the macroeconomic scenario prepared by the Government. As mentioned in Chapter 1, the greatest factors of uncertainty derive from the international scenario and, specifically, expected developments in world trade during the three-year planning period, which, through the exports channel, could adversely affect the Italian economy.

More specific risk factors for the achievement of the public finance objectives emerge from the analysis conducted by the PBO of a number of the budget measures, reported in Chapter 4. In this section, the focus is on:

- with regard to measures to combat tax evasion:
  - the scale of the recovery of revenue associated with the quarterly VAT reports is subject to uncertainty given the possibility that this measure could encourage other forms of evasion (evasion by agreement of the parties and evasion in sales to final consumers). Furthermore, some of the increased collections resulting from an increase in taxpayer compliance will presumably flow into the coffers of the special-statute regions, which have the right to keep part or all of the tax revenue collected in their territory. This share of revenue would not go towards improving the public finances, but rather towards financing increased spending capacity for those regions.

- the estimate of the relief for tax arrears for 2000-2015 is uncertain due to the limited information on the amount of arrears that is uncollectible[5] (the likelihood of uncollectibility rises as time passes) and due to uncertainty about taxpayer participation, which reflects their assessment of the financial advantage of doing so and is difficult to predict;
- the expected increase in the revenue from the extension of the voluntary disclosure programme could turn out to be over optimistic given that the pool of those interested could be substantially depleted following the previous edition of the programme, even though international anti-tax-evasion strategies (including the Common Reporting Standard) could serve as incentives to participate. The establishment of a safeguard clause involving cuts in spending by the ministries reduces quantification risk, although the sustainability of the impact of any such reductions in resources on the functioning of government departments must be considered.

- with regard to the measures in favour of firms:

  - the loss of revenue owing to the increase in allowable depreciation charges is at risk of being underestimated. Using the latest Istat statistics, while still making conservative assumptions, it is possible that the loss in revenue could be underestimated by almost 20 per cent (around €200 million in 2018 and €400 million in 2019, on a cash basis);
  - the projection of the loss in revenue connected with the introduction of the new income tax for entrepreneurs (IRI) does not appear to take into account the possibility that sole proprietorships who use simplified accounting rules could decide to apply ordinary accounting rules and opt for IRI. The additional cost associated with this expansion in the pool of IRI taxpayers could be around €500-600 million.

- with regard to measures for the health service:

  - the confirmation and the increase in funds for innovative pharmaceuticals (€500 million more than in 2016) within the total funding for the national health service requires the regions to identify other ways to offset the additional costs;
  - the ability of the ordinary-statute regions (OSRs) to cope with any further reduction in funding from 2017 – envisaged if the special-statute regions (SSRs) and the autonomous provinces fail to pay by 31 January 2017 the contribution provided for in the 2016 Stability Act (an amount that could exceed €400 million) – must be properly assessed.

- with regard to measures on local government finance:

[5] A debt is uncollectible when, among other circumstances, the debtor is involved in insolvency proceedings or precautionary or enforcement actions, the debtor is destitute, the debtor company has ceased operations or the debtor has died.

- the creation of the new fund for providing local government with additional financial resources "only in terms of the net balance to be financed" could have a negative impact on net borrowing and debt that is difficult to identify due to the lack of clear criteria for constructing the trend developments. The requirement that the beneficiary entities of the fund in 2017 show a surplus could also put pressure on their public finances in subsequent years, prompting requests for waivers of the balanced budget requirement (in addition to expanding the spending capacity of the entities in compliance with that requirement);
- the assumption of a reduced use of the resources generated by the waivers of the balanced budget requirement for spending on investment could prove to be imprudent given the incentive mechanism for reducing overshooting;
- the implementation of the agreements reached last summer with the region of Sicily, providing it with resources to expand the reference base for the regional income tax surcharge, would most likely translate into an increase in the region's spending capacity.

2.4 Comments on the recent changes in budget procedures and documents

The budget session now under way represents the first application of the changes to the public accounting and finance law introduced in 2016 to make it consistent with the 2012 reform of Article 81 of the Constitution and the consequent implementing provisions contained in the law establishing the balanced budget principle.

Following the 2012 constitutional reform, in August of last year amendments were made to the provisions of the public accounting and finance law that govern the budget planning calendar and the content of the law approving the State budget[6] (which also incorporates the content of the former Stability Act). Also in 2016, two additional legislative measures were approved that, completing the implementation of the enabling authority to modify the public accounting law, changed the structure of the State budget with the introduction of "actions" within expenditure programmes and the strengthening of the cash-based budget.

2.4.1 The new budget planning calendar

The budget approval session under way is the first to be conducted in accordance with the new calendar established with the reform of the public accounting law.

Specifically, the presentation of the Update to the EFD was postponed from 20 to 27 September, while the presentation of the Budget Act to Parliament, which incorporates

[6] Law 163/2016 amending Law 196/2009.

the content of the now defunct Stability Act, was pushed back from 15 to 20 October. As highlighted in the report that accompanied the bill,[7] the changes to the calendar were intended to meet the needs of the various institutional players involved in the budget process more effectively.[8] During the hearing of the PBO on 26 May 2016, some concern was already voiced:[9] the first-time application of the new calendar revealed additional complexities associated with the current timetable.

While it is indeed true that postponing the presentation of the Update to the EFD enabled the Government to take account of the revision of the annual national accounts, released by Istat on 23 September, the gap in time between the release of the new data and the publication of the Update to the EFD was very short, given that the Government had four days in which to incorporate the revised accounting into the trend macroeconomic scenario projections and submit it again to the PBO for assessment (the process between the PBO and the MEF had already begun on 7 September with the transmission of the initial trend scenario projections). The PBO also had to update its assessment within a very tight timeframe. In addition, the new time schedule for the Update did not allow the Government to obtain the quarterly national accounting data before its publication. The data were released by Istat on 3 October, making it necessary to alter, albeit marginally, the Update's macroeconomic trend and policy scenarios.

Similar issues arise with respect to the structure and timing of presentation of the Budget Act, which – as a result of the elimination of the Stability Act – for the first time serves as the single instrument for establishing the three-year public finance package (see section 2.4.3 for more detail). As noted on multiple occasions, the deadline for presentation to Parliament of the Budget Bill of 20 October falls after that provided for in the EU framework (15 October[10]) for the presentation of the DBP to the European Commission and to the Eurogroup, a document that requires reporting of the financial effects of the contents of the Budget Bill. This timeline required that the Budget Bill be approved by the Council of Ministers on 15 October (to determine the contents to be submitted to the European institutions). Then, however, the Bill was submitted to Parliament on 29 October, considerably later than the approval by the Council of Ministers, thereby significantly eroding the total time available for a parliamentary reading of the document. The length of time between the approval by the Council of

[7] See Chamber of Deputies Act no. 3828.

[8] The original bill (AC 3828) provided for postponing the deadline for the presentation of the Update to Parliament from 20 to 30 September, while for the Budget Bill an earlier deadline – 12 October - was set for the deliberation by the Council of Ministers, and a moving deadline of 12 days following such deliberation was established for its presentation to Parliament. This procedure could be waived if the Update retained the planned budget objectives indicated in the EFD. In this case, the Government could present the Budget Bill at the same time as the Update (by 30 September).

[9] For a description of the reform, see the *"Audizione del Presidente dell'Ufficio parlamentare di bilancio nell'ambito dell'indagine conoscitiva sul contenuto della nuova legge di bilancio e sull'equilibrio di bilancio delle Regioni e degli Enti locali, di cui alla L. 243/2012",* before the joint session of the Budget Committees of the Chamber of Deputies (V – Budget, Treasury and Planning) and the Senate (5 – Economic Planning, Budget), 26 May 2016.

[10] Based on the recent amendments to the public accounting law, the DBP was also sent by the same date to Parliament (Law 196/2009, Art. 9, para. 1-*bis*).

Ministers and the transmission of the document to Parliament depends in part on the complexity of the new budget document, which requires the preparation of a second section that incorporates the effects of the first section and the preparation of a comprehensive set of detailed schedules. The delay in the presentation seems mainly to have been caused by the fact that the measures were approved by the Council of Ministers "subject to further modification", a qualification that reflects a still incomplete determination of the details at the time of their review. Therefore a certain number of days were needed to complete the budget measures and to prepare the technical documentation. Better planning of the measures, starting with the EFD and then with the Update (see Section 2.4.2), should seek to overcome these delays, informing Parliament and the nation of the details of the measures approved on the same day they are transmitted to the European Commission.

2.4.2 The new content of the Update to the EFD

Along with the new presentation calendar, the legislative changes noted above also altered the content of the Update to the EFD, which must report the main areas of intervention of the public finance measures for the subsequent three-year period, with a brief explanation of the expected financial impact on revenue and expenditure, to achieve policy objectives.

In this case, too, the changes should have made it possible to better satisfy the requirements of the institutional players involved in the budget decision to perform their functions. The Government could have incorporated in the Update the information pertaining to the final public finance figures updated as reported by Istat in the second notification of general government net borrowing and debt, which must be transmitted to the European Commission by 1 October. The PBO would have obtained more information on the budget measures for the purposes of its validation of the policy scenario. In turn, the Government would have been facilitated in drafting the second section of the Budget Bill, which also incorporates the effects of the changes introduced in the first section.

The impact of these additional details on the public finance measures was assessed by the PBO at the hearing of 26 May[11] as an upgrade of the information content of the planning documents, which was also likely to improve the quality of the analysis performed during the procedure of validating the macroeconomic policy scenario. It should be noted that this clarification of the content of the planning documents was consistent with the approach set out in the accounting legislation up until the introduction (in 1988) of the economic and financial planning phase in the Italian budget framework. While widely disregarded in practice, specific regulatory requirements

[11] See Note 9.

provided that the planning documents set out the structure of the provisions to be adopted subsequently with the budget package.

During the hearing it was emphasized that the presentation of an Update containing a general outline of the main measures with their associated financial impact would have facilitated compliance with the session timetable that is objectively impacted by intersection of the presentation of the Budget Bill to Parliament (by 20 October) and prior transmission to the European Commission of the DBP (by 15 October), in which, in addition to the draft budget for the subsequent year with the budget balance objective and the policy scenario for revenue and expenditure, must contain specific information requiring a full description of the financial impact of the provisions of the bill for the subsequent three-year period.

Thus, observance of the deadlines under the new timetable appears to depend on the approval of the Budget Bill by the Council of Ministers by 15 October (or even earlier, to permit the preparation of the accompanying tables in the DBP). This condition can only be met if it is possible to move forward, in the Update, the actual determination of the public finance policy scenario with a breakdown of the revenue and expenditure macro-aggregates, accompanied by information on the essential gross budget measures, namely the decision on the total resources and their allocation, with more detailed guidance on key measures. This would also benefit the validation procedure for the macroeconomic policy scenario projections, a key element of which is the use of econometric models for forecasting the impact on economic growth of the main measures that the Government intends to adopt to achieve the public finance objectives.

Moreover, the advantages of moving forward the timetable, as provided for in the public accounting law itself, by publishing in the EFD the outline of the policy objectives by subsector and the policy development of the main general government aggregates, have been stressed repeatedly. Moving this forward would have a positive impact on the quality of public policies, would contribute to reinforcing the expectations of economic operators, thereby stabilizing the climate of confidence, and would facilitate the work of public administrators, especially at local level.

In the hearing, the PBO also emphasized the alternative possibility of presenting the Update and the Budget Bill on the same date, prior to the date for the submission of the DBP. In this context, the PBO would perform the validation of the macroeconomic policy scenario, having access to the complete set of information on the sectoral and strategic priorities proposed by the Government and within appropriate timeframes for use by the Parliament, which, by 15 October, would be able to debate the updating of the economic and financial planning, providing the Government with the relative guidance prior to the presentation of the DBP to the European Commission. After 15 October, Parliament would then move on to discussion of the measures contained in the new Budget Bill required to both achieve the policy objectives previously approved and to determine the policy priorities for public intervention considered as a whole.

The experience of the first-time application of the new legislation cannot be deemed satisfactory with respect to these issues. In fact, the Update to the 2016 EFD does not contain "an indication of the main areas of intervention of the public finance measures for the subsequent three-year period, with a brief explanation of the expected financial impact of the budget measures themselves on revenue and expenditure for the purposes of achieving the objectives."[12] Furthermore, there is no "planning report indicating the measures for reducing, eliminating or reforming tax expenditure in whole or in part unjustified or outdated in light of changing social or economic needs or that duplicate spending programmes having the same purpose, that the Government intends to implement with public finance measures,[13] while the "report on the results achieved in the area of fighting tax and contribution evasion, distinguishing between taxes assessed and collected as well as between different ways of initiating assessment procedures [...]" and containing "the strategies for combating tax and contribution evasion, updating and comparing the results with the objective"[14] was published only after approval of the Update by Parliament.

2.4.3 The new format of the Budget Act

The 2017 Budget Bill was prepared using a new format, consistent with the changes introduced by the recent legislative amendments mentioned above.

The scenario resulting from these changes necessitates a new format for the State budget, incorporating in this accounting document the contents of the former Stability Act and combining in a single document all the public finance measures for the three-year reference period. Very briefly, the State budget is divided into two sections, the first of which contains the provisions amending the existing legislation that contributes to achieving the public finance policy objectives (as defined in the planning documents). The second section contains the allocations of revenue and expenditure, incorporating in the financial values on a current legislation basis the effects of the changes arising from the measures contained in Section I and the purely quantitative changes adopted in Section II (refinancing, defunding and reprogramming).

The changes are to be welcomed: the budget proposal, whose goal is to modify priorities in the allocation of resources in accordance with the budget constraints, is more understandable than the fragmentation that has characterized the experience of recent years. The new budget document, on the one hand, shows the additional proposals with respect to trend developments, and on the other, makes it possible to differentiate the treatment of items for which discretionary changes can only be implemented by

[12] Law 196/2009, Art. 10-*bis*, para. 1, letter c-*bis*.
[13] Law 196/2009, Art. 10-*bis*, para. 5-*bis*.
[14] Law 196/2009, Art. 10-*bis*.1.

modifying the legal parameters (forecast expenditure) from those requiring a mere quantitative adjustment by legislative authorization (predetermined expenditure).

The new approach therefore required a change in the presentation of the effects of the measures adopted with the budget decision on public finance aggregates. Based on a scan by column in order, the new budget format makes it possible to immediately understand the effect of amendments to existing legislation on the amount of individual appropriations, providing for each item, with separate accounting records: the forecasts on a current legislation basis, the reprogramming measures offsetting the expenditure associated with discretionary earmarked appropriations and discretionary non-earmarked appropriations (proposed by the government departments during the budget formulation phase), refinancings, defundings and reprogrammings proposed in Section II of the budget and the effects of the measures inserted in Section I, to finally arrive at a final financial figure that corresponds to the comprehensive budget. The breakdown is presented by ministry-category and by category-ministry, with a further breakdown by programme (item upon which Parliament votes); for explanatory purposes the actions and chapters are listed, as well as descriptions by macroaggregate and economic category.

What emerges is an undoubtedly more compact and readable picture of the decisions on revenue and expenditure made with the overall budget package that, while setting out the steps mentioned above "in clear", makes it possible to understand from the time of presentation of the Budget Bill the actual and full deliberative scope of the government budget, casting aside an approach that was excessively focused on marginal changes. Under the previous format, in fact, only subsequent to the approval of the measures included in the Stability Act was a Note on the changes published, incorporating the effects on the individual budget appropriations and achieving a comprehensive integrated budget only at the end of the decision-making process. The new format is therefore undoubtedly an improvement with regard to the ease of understanding and the transparency of decisions on allocations submitted to Parliament for approval.

The first-time application of the new budget format, however, prompts a number of observations regarding the improvement of the information available to policy-makers.

In the report on the Bill, it is rightly pointed out that an "integrated budget" approach means that for the first time a technical report (TR) on the "entire" budget can be prepared. This initial experience has shown, however, that there continues to be a dichotomy between the information on Section I, which as was "traditionally" done in the Stability Act (and before that the Finance Act and associated measures) quantifies the individual legislative measures contained therein, reporting the effects in a specific financial schedule (formerly Annex 3), and the information accompanying Section II, which focuses on the effects of changes to current legislation introduced by non-

regulatory measures, such as refinancings, defundings, and reprogrammings.[15] The report on the budget highlights developments in the main revenue and expenditure aggregates and the various public finance balances on a current legislation basis only. For example, in describing developments in tax revenue, it points out the effects associated with the increase in the VAT rate in the three-year period forecast on a current legislation basis as a result of the safeguard clause (an increase, as stated, that is deactivated under the policy scenario), while the financial impact of the deactivation of the clause is quantified in the TR under the corresponding provision of Section I. It seems appropriate that the report should instead refer to the integrated flows of revenue and expenditure missions/programmes, showing developments on a current legislation basis and, especially, the final comprehensive result of the budget measures.

Despite the inclusion of the schedules summarizing financial impact in the new Budget Bill, it still lacks clear and comprehensive information on the effects of a considerable portion of the budget measures on general government, now set out in Section II. Specifically, the quantitative changes implemented in that section are described only in terms of the impact on the net balance to be financed of the State budget and not with reference to general government net borrowing, except in the totals reported in the summary schedules (former Annex 3) after the schedule quantifying the provisions, and only in aggregate form (current and capital expenditure). Therefore, the coexistence within a single document of different approaches to intervention in current legislation, on the one hand through regulatory measures (Section I), and on the other through quantitative changes (Section II), makes clear the need for better reconciliation between the State budget and government departments, overcoming the existing opaqueness of the accounting and the traceability of the effects of the measures.

In any case, from a purely technical standpoint, the manner of presenting these effects could be improved to make the information more readable and easier to use. There is a general need to better reconcile the schedules in the various parts of the measure.

An example of lack of transparency is found in Article 61 of the Bill, addressing spending cuts by the ministries and the Office of the Prime Minister, which contribute quantitatively to the budget measures. The information contained both in summary for Section II and in more detail in the table for the ministries inserted in the technical report[16] do not permit an immediate assessment of the cost savings, for which a more detailed description is needed. Looking forward, with the implementation of the spending review process in the budget cycle, the features of the measures taken by the ministries should be determined ahead of the usual timeframe for the ministries' proposals and therefore could be available in detailed form when the budget measures are presented.

Another significant example is Article 82, which extends the "culture allowance" to those who turn 18 years of age in 2017. This measure, which would require a new legislative expenditure authorization to be quantified in the schedule summarizing the financial effects of Section I, is instead presented as a refinancing of the expenditure authorization already provided for on a

[15] Basically, this refers to the contents of Tables C, D and E attached to the Stability Act.
[16] It distinguishes between revenue and expenditure measures, and indicates the section (I or II) of the bill in which the changes to the budget are made.

current legislation basis for the payment of the allowance to those turning 18 in 2016 and therefore falls under Section II.

As further examples, the inclusion of the total in all the schedules in Section II would aid understanding of the overall contribution of the section. Separating the columns relating to refinancings from those on defundings and reprogrammings would make it easier to identify the items constituting resources and uses. The addition of indices by ministry budget and mission in the .pdf files would facilitate searching through the vast number of pages forming the document. The availability of files in editable format would permit more flexibility in setting out the contents of the budget measures.

The adoption of a single instrument for budgetary decisions could herald desirable, further changes in the structure of the budget and the annual budgeting process. A first step would be to prioritize measures that quantitatively regulate the financial aggregates allocated to the various sectors, completing a unified vision of the choices on the allocation of resources and postponing to a later phase the approval of sectoral measures. This, on the one hand, would avoid overloading the budget with minute details on implementation, making it possible to focus on the choices made in allocating resources. On the other, it would enhance the role of the ministries and the relevant Parliamentary committees, which was often compromised by the examination of specific measures in the Stability Bill, which in the end were examined with very pressing time constraints by just the Budget Committees. An example is the "Good Education" reform measure in the 2015 budget: the Stability Act identified the additional resources for the sector, with a broad description of the purpose, while subsequent provisions (which maneuvered within the amount of the appropriated resources) determined how the funds would be spent.

It would also be helpful to make an effort to standardize the terminology used in the accounting legislation, especially with regard to differentiating between "*spese predeterminate*" (predetermined expenditure) and "*spese previste*" (planned expenditure), on the one hand, and "*fattori legislativi*" (discretionary earmarked appropriations), "*oneri inderogabili*" (mandatory expenditure) and "*adeguamento al piano finanziario dei pagamenti*" (discretionary non-earmarked appropriations)[17] on the other. The latter is a classification maintained in the reform of the budget format, but may require further reflection given the changes introduced. Doing away with the formal nature of the budget might suggest abandoning the classic three-part structure, eliminating items classified as *adeguamento al piano finanziario dei pagamenti*, which in fact reflect appropriations that could be changed directly in the budget in the past, unlike those requiring action within the Stability Bill. In addition, it could be useful to simplify the existing framework with gradual convergence of the two remaining categories (*oneri inderogabili* and *fattori legislativi*) with the other classification of expenditure (*spese predeterminate* and *spese previste*): *oneri inderogabili* would converge with *spese previste*, and *fattori legislativi* with *spese predeterminate*. It should

[17] New title for items previously classified as "*adeguamento al fabbisogno*".

be noted that these definitions are of some importance for controlling spending in both the legislative and operational phases.

Finally, the new unified budget – grouping in Section II the decisions on financing or defunding of expenditure laws – improves the commonality of vision of the financial decision, but avoids the issue of the relationship between programme (item upon which Parliament votes) and the discretionary earmarked appropriation (*fattore legislativo*). As already noted in a previous hearing,[18] the spending programme has not so far played the role it was assigned. The items classified as *fattori legislativi* have constituted a constraint on use during the execution phase, arising from authorizations voted by Parliament, that is "stronger" than the programme, also approved by the Parliament, but until now as part of a formal instrument. The vote on the individual law therefore took precedence over the vote on the budget, keeping alive that fragmentation in the presentation of public policies that the introduction of programmes and missions was meant to resolve. In this way, the vote on a programme is virtually meaningless and opaque. The unified budget, together with the introduction of actions and the reorganization of programmes, offers an opportunity for a broader reflection on the issue, reviving the review of the legislation underlying the programmes in order to revise, rewrite and clean up the entire body of expenditure laws that underpin the current budget.

[18] "*Le prospettive di riforma degli strumenti e delle procedure di bilancio*", hearing of the Chairman of the PBO, Giuseppe Pisauro, before the joint session of the Budget Committees of the Chamber of Deputies and the Senate as part of the fact-finding inquiry into the outlook for the reform of budget instruments and procedures, 14 July, Rome.

3. THE FISCAL RULES

The consistency of the public finance scenario with rules on the structural balance and expenditure depends on at least two critical factors: a) the recognition of the costs associated with the flow of refugees and those relating to enhancing earthquake resistance as exceptional and their consequent exclusion from the structural balance; b) the size of the correction the country must make in relation to economic conditions- normal or bad times - as measured by the output gap. In the event of a favourable solution to both of these issues (recognition of the impact of exceptional events and the fact that the country is going through bad economic times), the objectives in the DBP would represent a close-to-significant deviation for the structural balance rule and an insignificant deviation for the expenditure benchmark. If the events are not recognized as exceptional, the DBP objectives would be at risk of a significant deviation for both rules. Regardless of these elements, the debt reduction objectives in the DBP do not appear consistent with any of the criteria (backward-looking, forward-looking and adjusted for the cycle) used to assess compliance with the associated numerical rule. Compliance with that rule therefore depends on consideration of the relevant factors.

On the basis of current information, it is not possible to predict what the Commission's decision will be. The criteria for calculating the output gap are also being discussed in the appropriate technical fora at the urging of the Italian Government. As for the influx of refugees, last year the Commission had already recognized that it qualified as an exceptional event, allowing the exclusion of any expenditure in excess of such spending the previous year. The decision for 2017 would therefore not appear to regard the nature of the phenomenon but rather the amount of expenditure to be excluded.

As regards the earthquake-resistance effort, there are no precedents for exclusion from the required adjustments of expenditure on prevention measures. The increased frequency of earthquakes in the period may correspond to greater risk for the country compared with the past, making extraordinary preventive action necessary. There are a number of challenges in placing an extraordinary plan for enhancing earthquake resistance within the scope of the exceptional events exception for the purposes of the European rules. First, the room for additional expenditure requested (0.2 percentage points of GDP) includes not only new resources but also the impact on the accounts of measures taken in previous years (already in the current-legislation budget) associated with more general building renovation and energy efficiency efforts. Second, the request to exclude expenditure for 2017 only does not appear consistent with the necessarily long-term nature of any seismic upgrading plan.

3.1 The Government's requests: flexibility and exceptional events

In the last two years, the Government's action has been conducted within the flexibility arrangements available under European rules as specified by the Commission in its Communication of January 2015.[19] In addition, for 2015-2016 the Commission, for the first time, allowed the exclusion of certain measures necessary to cope with exceptional events from budget adjustments.

It is first necessary to distinguish between one-off budget measures (see section 3.2) and the exceptions granted for exceptional events. As they are non-recurring, the former - composed of non-structural revenue and spending measures - are identified in order to exclude them from the reference balance for determining compliance with the European fiscal rules. They can be classified and are identified using the classification methods mentioned earlier. The exceptions connected with exceptional events are associated with circumstances that call for the temporary, and normally partial, suspension of the fiscal rules in order to permit adoption of measures to counter the impact of those events. The very definition of such events as exceptional means that they cannot be classified and are governed on a case-by-case basis with *ad hoc* rulings of the Commission. Particular care is needed in distinguishing the two if they are both included in the same budget.

The flexibility allowed under the preventive arm of the Stability and Growth Pact takes the form of greater budget flexibility in achieving the medium-term objective (MTO)[20] or the path of adjustment towards the MOT. The Commission Communication specifies the scope of flexibility, which permits deviations from the required budget adjustments and can be granted in response to: 1) specific cyclical conditions in the economy; 2) the adoption of structural reforms; and 3) to permit specified investments. In addition, the European rules allow the exclusion from budget adjustments of certain expenditures connected with exceptional events.

First, the deviation connected with cyclical conditions is possible thanks to a more country-specific orientation of policy, based not just on debt but also on a broader and more detailed breakdown of the cyclical position of the economies of the Member States.[21]

Second, the flexibility connected with the structural reform clause[22] is granted for the implementation of comprehensive measures that, while increasing expenditure in the short term: 1) are major; 2) are fully implemented (through legally-binding measures and, in view of the possibility of setbacks and delays in implementing complex reforms, providing for monitoring of implementation[23]); and 3) have a verifiable impact on the long-term sustainability of the public finances. This impact may be a direct impact on the budget or an indirect effect through an increase in potential GDP and thus higher future revenue.

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[19] In the Commission Communication of 13 January 2015 entitled *"Making the best use of the flexibility within the existing rules of the Stability and Growth Pact"*.

[20] For Italy, this consists in bringing the budget into structural balance, i.e. net of the effects of cyclical conditions and one-off measures.

[21] As indicated in the matrix annexed to the Commission Communication *"Making the best use of the flexibility within the existing rules of the Stability and Growth Pact"*, op. cit.

[22] See European Commission (2016), "*Vademecum on the Stability and Growth Pact – 2016 edition"*, *European Economy, Institutional Paper 21*, March; PBO (2015), "*2016 Budgetary Policy Report*", November.

[23] The Commission and the Council of the EU track progress and assess the challenges and imbalances in the context of the European Semester and the Excessive Deficit Procedure (EDP), which form the legal framework for the process.

In addition, under the investment clause[24] certain types of investment are considered economically equivalent to structural reforms and, under specified conditions[25] – including the existence of bad economic times in the year the clause is invoked and the existence of credible plans for the resumption of the adjustment path towards MTO[26] – may justify a temporary deviation from that path.[27] An investment can be considered economically equivalent to the implementation of structural reforms only if it can be demonstrated that it would have a major verifiable net positive impact (direct and indirect) on potential output and on the sustainability of the public finances. Investments that meet these standards for this purpose are those involving national expenditure on projects financed with European co-financing through the structural and investment funds[28] (ERDF, ESF, EAFRD, EMFF and YEI[29] provided for under Regulation (EU) 1303/2013), expenditure for Trans-European Networks (TEN) and expenditure for the Connecting Europe Facility (CEF), as well as national financing of projects co-financed through the European Fund for Strategic Investments (EFSI).

Finally, expenditure for exceptional events, while recognised for the purpose of assessing deviations from the adjustment path towards the MTO, must not jeopardise the medium-term sustainability of the public finances. The recognition of an event as exceptional and the quantification of the associated expenditure are assessed by the Commission.

At the end of September, the President of the European Commission referred to an amount of €19 billion in total flexibility granted to Italy in 2015-2016[30]. There were various components of that flexibility (Table 3.1):

Table 3.1 – Deviations under flexibility clauses approved for Italy in 2015-2016 under: a) the Commission Communication on flexibility of January 2015; and b) the effects of exceptional events
(millions of euros)

	% GDP		Absolute values		Total
	2015	2016	2015	2016	2015-2016
(a) Economic cycle (1)	0.25		4,106		4,106
(a) Reforms		0.5		8,361	8,361
(a) Investment		0.25		4,181	4,181
(b) Immigrants	0.03	0.04	571	703	1,274
(b) Security		0.06		950	950
Total	**0.28**	**0.85**	**4,677**	**14,195**	**18,872**
GDP 2016 Update			*1,642,444*	*1,672,226*	

Source: based on European and national documentation.
(1) The deviation connected with the economic cycle has been calculated with respect to the path of adjustment towards the MTO required before the Commission Communication on flexibility.

[24] See the Commission Communication of 13 January 2015, op. cit., and the *Commonly agreed position on flexibility within the Stability and Growth Pact*" approved by the Ecofin Council on 12 February 2016.
[25] See Box 4.1 "*Requirements of the investment clause*" in PBO, "*2016 Budgetary Planning Report*".
[26] As indicated in the Commission's Opinion on the 2016 DBP 2016 and in the Opinion of the European Council on Italy's 2016 Stability Programme.
[27] See also "*Vade Mecum on the Stability and Growth Pact*" 2016 edition.
[28] For more on the use of the European structural and investment funds within the scope of the Juncker Plan, see l'Audizione dell'Ufficio parlamentare di bilancio nell'ambito dell'indagine conoscitiva sul Piano di investimenti per l'Europa of 25 February 2015.
[29] ERDF: European Regional Development Fund; ESF: European Social Fund; EAFRD: European Agricultural Fund for Rural Development; EMFF: European Maritime and Fisheries Fund; YEI: Young Employment Initiative; Italy does not participate in the cohesion fund as it is devoted to promoting the convergence of less-developed regions.
[30] Statement of President Juncker to the European Economic and Social Committee in Brussels on 22 September 2016.

- *with regard to the economic cycle*, for 2015 the deviation granted to Italy from the benchmark adjustment (equal to 0.5 percentage points di GDP) amounted to 0.25;

- *with regard to structural reforms*, for 2016, the deviation granted to Italy amounted to 0.5 per cent of GDP. The flexibility requested for the implementation of reforms, initially equal to 0.4 per cent of GDP, regarded a number of areas of intervention: public administration, competition, the legal system, education, labour market, rebalancing of tax burden in favour of taxation of labour and profits, intensification of the spending review. Following measures addressing impaired loans and bankruptcy procedures, an additional 0.1 percentage points of flexibility were requested;

- *with regard to investments*, for 2016, Italy was allowed a temporary deviation from the adjustment path of 0.25 per cent.[31] In mid-February 2016, the Government sent the European Commission a document detailing the composition of the expenditure of €5.15 billion for which the activation of the clause was being requested, with an associated €6.15 billion in European co-financing. Subsequent policy documents did not report on the effective implementation of the investment plan. Under the clause, if the flexibility granted was not entirely used in 2016, the remainder could be exploited in 2017 up to the limit of the eligible incremental investment over the previous year;

- *temporary deviation from the path of adjustment towards the MTO permitted as a result of recognition of exceptional events*. In 2016, the European Commission recognised the immigration emergency and the strengthening of security as exceptional events. More specifically, as regard immigration flows, the Commission accepted only the increase over the previous year of expenditure for each year of the 2015-2016 period as connected with an exceptional event. For Italy, the flexibility granted amounted to 0.03 per cent of GDP in 2015 and 0.04 per cent in 2016. Finally the European Commission also allowed the spending on increased security measures following the terrorist attacks in various European countries to be considered connected with an exceptional event. For 2016, the flexibility granted was equal to 0.06 per cent of GDP for specific areas of intervention (cyber security: the beefing up of measures and tools for cyber and information security, with the establishment of a specific fund at the MEF with an appropriation of €150 million for 2016; equipment: to modernise equipment, including that for personal protection, of the armed forces, the police and firefighters, with the establishment of a special fund at the MEF with an appropriation of €50 million; a monthly tax credit of €80 for law enforcement personnel for a total cost of €500 million; investments in defence and security: in order to support exceptional measures for defence and public

[31] European Commission (2015), "*Commonly agreed position on flexibility within the Stability and Growth Pact*".

safety, with a specific focus on anti-terrorism capabilities, with a fund established at the Ministry of Defence with an appropriation of €250 million).

For 2017, the Government has presented a budgetary plan which envisages expenditure totalling 0.4 per cent of GDP linked to events considered exceptional, namely the large recent immigration flows and the frequent seismic events of recent years.

In addition, the Budget Bill extends to 2017 certain security enhancement expenditures associated with exceptional events in 2016, such as the monthly tax credit of €80 for law enforcement personnel.

According to the DBP, half of this total amount (0.2 per cent of GDP) in linked to the continuation of the migrant emergency and the need for a policy that includes investment in key countries of migrant origin and transit. However, the calculation to quantify the temporary deviation from the adjustment path towards the MTO regards not the increase on the previous year, as previously allowed by the European Commission, but rather the incremental expenditure in 2017 with respect to that incurred several years earlier, when the emergency had not yet occurred, equal to the average spending registered in 2011-2013.

The other 0.2 per cent of GDP is connected with the earthquakes of recent years. The exceptional nature of the expenditure is connected with the need to take more incisive preventive action to safeguard earthquake-prone areas of the country, first and foremost with resources to counter hydrogeological damage and enhance the safety of buildings, schools in particular.

The expenditure on preventive action to reduce seismic risk cannot be classified as one-off spending under European classification criteria: in addition to reconstruction spending these only allow such classification for preventive expenditure strictly necessary to prevent any additional harm above and beyond that caused by a calamity that has already occurred. The Government has therefore submitted a request for the recognition of the need to undertake preventive action to secure buildings and territory in Italy as exceptional and to therefore excluding the expenditure consequent upon such action from the structural balance.

In the response to the European Commission's request for clarification concerning the DBP,[32] the Government provides additional information on the two exceptional events. It emphasises that spending on the immigration crisis should not be evaluated solely in terms of changes compared with the previous year but rather with respect to the situation in which Italy would be if the country were not an external border of the European Union. Preliminary information is also provided on the financial requirements connected with the seismic upgrading programme.

In the hearing of 4 November 2016, the Minister for the Economy and Finance provided additional information concerning the composition of seismic safety spending, quantifying

[32] Letter of 27 October in reply to that of the European Commission sent to Italy on 25 October 2016.

total expenditure for post-earthquake reconstruction and prevention at about €6 billion. Table 3.2 shows a reconstruction of the items that make up the overall amount, distinguishing between funds for reconstruction, which are one-off expenditures, and those for prevention, for which recognition as an exceptional event has been requested.

Table 3.2 – Resources for earthquake reconstruction and prevention
(millions of euros)

Resources	2017	*Sources*
Resources for reconstruction (one-off)		
Resources indicated in the Update (table of trend one-off measures)	**2,060**	*2016 Update*
Reconstruction (1)	*1,700*	
Other	*360*	
Resources appropriated with Decree Law 189/2016 for Umbria-Marche earthquake (2)	**191**	*Decree Law 189/2016*
Additional resources appropriated with 2017 Budget Bill (2)	**600**	*2017 Budget Bill*
Seismic emergency - Tax credit for private reconstruction	*400*	
Seismic emergency - Grants for public reconstruction	*200*	
Total resources for reconstruction *(one-off)*	**2,851**	
Resources for prevention (exceptional events)		
Share of investment in Budget Bill allocated for seismic prevention (3) (4)	**600**	*Hearing of Minister*
Fund to be allocated for revival of investment and development of the country	*279*	
Local authority budget balance - inclusion of restricted long-term fund	*135*	
Use of restricted surpluses for investments under national incentive pact - Local authorities	*109*	
Use of restricted surpluses for investments under national incentive pact - Regions	*78*	
Tax relief for renovations by private citizens (3) (5)	**2,000**	*Letter and hearing of Minister*
of which: incentives provided for in 2017 Budget Bill	*134*	
Public measures to counter hydrogeological damage and upgrading safety of public buildings (3)	**800**	*Hearing of Minister*
of which: projects for enhancing the safety of schools (6)	*230*	
Protection of hydrogeological conditions (7)	*87*	
Total resources for prevention	**3,400**	
Total resources for reconstruction and prevention	**6,251**	

Source: based on government documentation and measures.
(1) 2017 Budget Bill mission 8, programme 8.4, action "Reconstruction support", section II. – (2) Schedule of the financial effects of the measure. – (3) Letter of the Minister for the Economy and Finance sent on 27 October in response to the request for clarification from the European Commission of 25 October 2016 and/or hearing of the same minister of 4 November 2016. – (4) The €600 million indicated in the hearing of the minister represent about 45 per cent of the resources appropriated in Articles 21 and 65 of the bill. The percentage was applied to the individual items specified in the schedule of the financial effects of the Budget Bill for those articles. – (5) Includes instalments of tax credits granted in previous years. – (6) 2017 Budget Bill mission 22, programme 22.1, action "Measures for safety in state schools and for school building", section II. – (7) 2017 Budget Bill mission 18, programme 18.12, action "Land protection and defence, protection of hydrogeological conditions and representation of the territory", section II.

In addition to about €2.8 billion in one-off expenditure for reconstruction, amounts are specified for prevention projects amounting to about €3.4 billion (the 0.2 per cent of GDP noted earlier). This figure is composed of:

- part of the funds appropriated in the Budget Bill for investments in public works at the national and local levels (a total of about €600 million), thanks in part to the financial flexibility granted to local authorities;
- tax incentives for renovations by private citizens (about €2 billion), of which a minority share provided for in the Budget Bill and the remainder accounted for by residual instalments of tax credits granted under previous tax incentive mechanisms. With regard to the tax incentives provided for in the 2017 Budget Bill, the hearing the Minister for the Economy and Finance of 4 November 2016 included measures for energy efficiency initiatives and building renovations as well as seismic upgrading measures. Presumably this subdivision also applies to the residual instalments of tax credits;
- public initiatives to counter hydrogeological damage and ensure the safety of public buildings (about €800 million), schools in particular. Appropriations for school building and preventing hydrogeological damage amount to €230 million and €87 million respectively. The remainder could regard possible expenditure included under other State budget items as well as spending by local authorities.

3.2 One-off measures

The budget package for 2017 contains a range of measures classifiable as one-off under the EU's criteria. These criteria were recently reformulated[33] in greater detail in order to limit discretion in identifying such measures, whose exclusion or inclusion in the calculation of the structural balance can change the budget positions of the individual Member States for the purposes of compliance with European fiscal rules.

Measures classified as one-off impact the actual budget balance (improving it in the case of revenue increases[34] and worsening it in the case of spending increases) but they do not impact the structural balance, which does not comprise such items. The net difference between the actual and structural balances associated with the effect of the one-off items will therefore depend on the prevalence of revenue or spending measures, whose respective positive or negative effect will be removed from the structural balance. Accordingly, if one-off revenue

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[33] See *Report on Public Finances in EMU* of December 2015, part II, chapter 3. For a summary of the methodological criteria discussed there, see the box on p. 17 of Focus tematico PBO n. 1/2016, "*La 2016 Stability Act nel quadro programmatico dei conti pubblici*".

[34] For the sake of simplicity in discussing revenue measures, in this section reference is also made to revenue from the sale of tangible and intangible assets, such as property sales or the award of frequency use rights, which under ESA2010 are registered in the accounts on the expenditure side as a reduction in investments. Table 3.3 classifies one-off amounts under revenue and expenditure in accordance with the ESA2010 classification rules.

measures dominate, the structural balance will worsen by comparison with the actual balance and vice versa if spending measures dominate.

The DBP for 2017 attributes a positive two-tenths of a point of GDP to one-off measures (worsening the structural balance with respect to the actual balance) and a negative one-tenth of a point in the two subsequent years (improving the structural balance with respect to the actual balance), without providing details on the individual measures, however. Such detail was provided in the Update for the one-off measures included in the trend scenario, which were estimated to have an overall impact of zero. Taking these trend measures and analysing the policy provisions contained in measures subsequent to the publication of the Update, we can obtain a hypothesis about the breakdown of the one-off measures referred to in the DBP in aggregate form only (Table 3.3).

The impact of the one-off measures in terms of GDP indicated in the DBP appears to have been determined by summing the temporary trend measures in the Update with those in the Budget Bill 2017 and in Decree Law 189/2016[35] classified on the revenue side (extension of the voluntary disclosure mechanism, separate taxes on the redetermination/revaluation of corporate assets, equity investments and land and the proceeds of the *superenalotto* gaming tender) and expenditure side (tax credits for private reconstruction, grants for public reconstruction, auction of telecommunications frequency use rights,[36] spending for the Umbria and Abruzzo earthquakes). It can be deduced that the Government did not include the anti-tax-evasion measures in Decree Law 193/2016 among the one-off measures, despite the fact that those provisions appear to meet the EU's criteria for classification as such.

Some of the revenue provided for in Decree Law 193/2016 risks being classified as one-off, especially that generated by:

- the amnesty for tax arrears (Article 6, which is expected to generate €2 billion in additional revenue in 2017, and €0.4 billion in 2018 and 2019): this appears to fall in the category[37] of measures that entail a short-term lump-sum benefit at the expense of a recurrent future cost, given that the provision allows the early payment of tax arrears that will not be collected in the future;
- the acceleration of methods of verifying non-payment (Art. 4, paragraphs 2, 5 and 6, whose effects are put at €0.7 billion in 2017 and €1.4 billion in 2018): this appears to fall in the category[38] of a change in the timing of recurrent revenue that creates a temporary positive peak in the transition year between one steady state and another.

The risk that certain spending measures classified as one-off in the trend budget could be eliminated should also be assessed.

[35] Containing support measures for the areas affected by the earthquake.
[36] As noted earlier, the receipts from this measure should be classified as a reduction in expenditure in the general government account under ESA2010.
[37] Principle 1.b for the classification criteria set out in "*Public finances in EMU 2015*", part II, chapter 3.
[38] Principle 1.c of those criteria.

Table 3.3 – One-off measures in the 2016 Update and 2017 DBP
(*millions of euros and percentages of GDP*)

	2017	2018	2019
2016 Update			
Total trend one-off measures - % of GDP	**0.0**	**0.0**	**0.0**
Total trend one-off measures - absolute value (a)	**-42**	**-820**	**-830**
a) Revenue	1,138	140	10
Voluntary disclosure	*800*		
Sundry separate taxes	*328*	*130*	
Building amnesty	*10*	*10*	*10*
b) Expenditure	1,180	960	840
Natural disasters	*2,060*	*1,860*	*1,740*
Property disposals	*-900*	*-900*	*-900*
Dividends paid	*20*		
2017 DBP			
Total policy one-off measures - % of GDP	**0.2**	**-0.1**	**-0.1**
MEASURES PRESUMABLY CONSIDERED ONE-OFF IN 2017 DBP			
2017 Budget Bill (AC 4127) (b)	**3,340**	**-661**	**-812**
Total one-off revenue measures	2,060	223	160
Separate taxes (Arts. 69-70)	*410*	*173*	*160*
Superenalotto gaming tender (Art. 73)	*50*	*50*	
Extension of voluntary disclosure *(Art. 86)*	*1,600*		
Total one-off expenditure measures	-1,280	884	972
Telecommunication frequency rights (Art. 72) (1)	*-2,010*		
Tax credit for private reconstruction (Art. 51)	*400*	*500*	*600*
Grants for public reconstruction (Art. 51)	*200*	*300*	*350*
Decree Law 189/2016 (c)	**-130**	**-84**	**-22**
Expenditure for Umbria-Marche earthquake	130	84	22
Total measures presumably considered in 2017 DBP (d=a+b+c)	**3,168**	**-1,565**	**-1,664**
Percentage of GDP	**0.2**	**-0.1**	**-0.1**
Memorandum item: Policy GDP in 2017 DBP	*1,705,841*	*1,758,962*	*1,812,933*

Source: based on Update documentation and schedules summarising the measures.
(1) In the summary schedule of the effects of the 2017 Budget Bill (AC4127), this item is also classified under non-tax revenue for the purpose of net borrowing, whereas according to ESA2010 it should be included under expenditure, reducing spending on capital account.

On the expenditure side, it would be necessary to verify whether spending for the areas affected by earthquakes that occurred too long ago (in particular, the 2009 Abruzzo earthquake) is at risk of exclusion from the trend one-off measures, in view of the principle that allows only measures introduced in direct response to exceptional events.[39] It is necessary to determine whether the 2-year criterion, indicated as a general rule for defining short term in the guiding principles for the classification of one-off measures, can be interpreted broadly.

[39] Principle 1.d of those criteria.

Where such risks should be realized, the impact of one-off measures on the actual balance could differ from that indicated in the DBP, worsening the structural balance and, therefore, threatening compliance with the fiscal rules.

3.3 Public finance targets in the light of the fiscal rules

Italian law establishes that the budget balance requirement envisaged in the Italian constitution is achieved when the structural balance is equal to at least the MTO, i.e. a balanced budget, or ensures compliance with the path of adjustment towards that objective in the case of deviations due to an exceptional event.[40] In addition, the rate of change in structural expenditure net of discretionary revenue must be consistent with the EU rules.[41] Finally, since the ratio of public debt to GDP exceeds the threshold of 60 per cent, the public finance targets must take account of the need to ensure an average annual reduction of one-twentieth of the excess over 60 per cent and of the relevant factors, consistent with EU law.[42] According to EU rules, compliance with the structural balance rule and the expenditure rule is assessed over one and two years.

3.3.1 The structural balance rule

In the DBP the Government expects structural net borrowing to deteriorate by 0.4 percentage points in 2017 compared with 2016 (from 1.2 per cent in 2016 to 1.6 per cent in 2017), even while maintaining the objective of essentially achieving structural balance (with a deficit of just 0.2 points of GDP) by 2019 as already established in the EFD published last spring.

As in the Update, for 2016 the deterioration in the structural balance is estimated at 0.5 percentage points in the DBP, exceeding that permitted by the European Union (0.35 points). Both the one- and two-year assessments confirm the risk of a deviation from the required adjustment, even though that deviation would not be significant.

The adjustment of structural net borrowing required for 2016 is determined on the basis of three components of different sign: 1) the effort required for countries that like Italy are experiencing bad economic times and have a debt/GDP ratio of more than 60 per cent (-0.5 percentage points of GDP); 2) the flexibility granted under the structural reform clause (0.5 points of GDP); additional flexibility under the investment clause (0.25 points di GDP); and 3) additional expenditure to manage the refugee crisis and boost security (0.1 points di GDP). The granting of this flexibility is subject to the Italian Government commitment to resume the adjustment path towards the MTO in 2017, with compliance with the commitment to be assessed in the autumn of 2016.

[40] Law 243/2012, Art. 3.
[41] Law 243/2012, Art. 5.
[42] Law 243/2012, Art. 4.

Under the assessment on an annual basis, the deviation from the required adjustment is smaller (in absolute value) than 0.5 points and should therefore not be significant. Even considering the 2015-2016 period, the average deviation would be about 0.2 points, in excess of the allowable average deviation (0.07) but still not significant.

As for 2017, the forecasts for the structural balance in the DBP differ from those in the Update because the Government decided, after requesting authorisation from Parliament, to exploit additional budget flexibility. The DBP therefore forecasts a deterioration in the structural balance of 0.4 percentage points (compared with no change in the Update), compared with a request for an improvement of “0.6 or more” percentage points from the EU Council in its recommendations last July, based on a proposal of the Commission. The Government argues that its decision is consistent with the European budget rules as spending equal to 0.4 per cent of GDP should be considered exceptional in view of the extraordinary flow of refugees and the heightened seismic risk (see section 3.1). In this case, the associated expenditure should be subtracted from the required adjustment.

In addition, in the DBP as well as the Update, the Government’s estimate of the output gap for 2017 is larger than that estimated by the European Commission last spring, which served as the basis for the recommendations. According to the estimates in the DBP and the Update, in 2017 Italy will be experiencing a period of bad economic times (with an output gap of more than -1.5) and therefore, under the criteria established at the EU level, the required fiscal adjustment should be 0.5 percentage points rather than 0.6 points.

Table 3.4 summarises the assessment of compliance with the structural balance rule in 2017 under different assumptions. Appendix 3.1 details the elements necessary to arrive at the assessments reported in Table 3.4 in the various cases considered.

If the events cited by the Italian Government were designated as exceptional to the extent specified in the DBP and the existence of economic bad times acknowledged, the deterioration in the balance proposed by the Government would be, on an annual basis, close to a significant deviation. Over a two-year period, the targets would be at risk of a significant deviation. If instead the estimated output gap pointed to normal times, the structural balance target proposed in the DBP would be at risk of representing a significant deviation from both the one- and two-year perspectives.

If the two events invoked in the DBP were not recognized as exceptional, the budget targets would be at risk of representing a significant deviation over both the annual and biennial time spans for both assumptions concerning the output gap.

Table 3.4 – Compliance with the structural balance rule in 2017 under different scenarios

		Without exceptional events	With exceptional events = 0.4
Normal times (adjustment matrix = 0.6)	In annual terms	Sig. dev.	Sig. dev.
	In biennial terms	Sig. dev.	Sig. dev.
Bad times (adjustment matrix = 0.5)	In annual terms	Sig. dev.	Close to sig.
	In biennial terms	Sig. dev.	Sig. dev.

For 2018, the improvement envisaged in the DBP in the structural balance would be considerable (0.9 points) and would ensure compliance with the rule on an annual basis. Nevertheless, in the absence of exceptional events in 2017, from the two-year perspective there would be a risk of a significant deviation in 2017-2018. In 2019, the improvement forecast by the Government would amount to 0.5 percentage points, and as it is below the requested 0.6 points could become a deviation, albeit not a significant one. On a two-year basis, the DBP scenario would comply with the rule in 2018-2019.

In conclusion, even in the event of a favourable interpretation of the exceptional circumstances by the European Commission, the structural balance targets set out in the DBP for 2017 are at risk of becoming a significant deviation or approaching significance. The targets for 2018-2019 are more closely in line with the rule but assume large structural adjustments that would involve the increases in the rates of indirect taxes indicated in the policy documents.

3.3.2 The expenditure benchmark

In 2016, Italy would comply with the expenditure rule on an annual basis but there would be a risk of deviation, albeit not significant, from the two-year perspective.

Using the information provided in the 2017 DBP, the rate of growth in the spending aggregate considered by the rule (in real terms and net of discretionary revenue) increased by 0.4 per cent on the previous year, compared with a target of 0.8 per cent. In 2015-2016, the average growth in the expenditure aggregate was 0.5 per cent, against a target of 0.2; as a ratio of GDP, that deviation would be equal to 0.13 percentage points and is therefore not significant.

As was already the case for the Update, for 2016 the expenditure rule is more favourable than the structural balance rule. A preliminary assessment shows that one of the primary reasons for this difference is the poorer performance of revenue net of one-off measures than would normally be expected in the forecast economic conditions (a revenue shortfall). This has a negative impact on compliance with the structural balance rule.

In 2017, the outcome of the assessment of compliance with the expenditure rule (as with the structural balance rule) depends on the designation of the cited events as exceptional (with flexibility of 0.4 points of GDP) and the determination of the cyclical position of the economy as reflected in the estimated output gap.

Table 3.5 summarises compliance with the expenditure rule in 2017 under the various assumptions involved. Appendix 3.2 provides a detailed analysis of the elements necessary to produce the assessment shown in Table 3.5 in the various cases under consideration.

If the events are not recognized as exceptional and Italy is judged to be in normal economic times (with an associated required adjustment of 0.6 percentage points as indicated in the matrix), the country is at risk of committing a significant deviation, consistent with the result obtained for the structural balance rule. Over a two-year period, the risk of deviation would be close to significant. If the estimated output gap places the country in bad economic times, the risk of a deviation would be significant on an annual basis, whereas that determined for the two-year perspective would still produce a deviation, but not a significant one.

If the events are recognised as exceptional, the targets in the DBP would – for both assumptions about economic conditions – represent a non-significant risk of deviation from the expenditure benchmark from an annual perspective. The same result would hold for the two-year perspective in normal economic times, but Italy would comply with the spending rule on a two-year basis if the output gap is found to indicate bad economic times for the country.

The expenditure rule also appears more favourable than the structural balance rule in 2017. An initial assessment reveals the main determinants of this outcome to be a revenue shortfall and an annual increase in investment spending that is faster than the four-year average rate. Both of these circumstances make it easier to comply with the spending rule than the structural balance requirement.

Table 3.5 – Compliance with the expenditure rule in 2017 under different scenarios

		Without exceptional events	With exceptional events = 0.4
Normal times (adjustment matrix = 0.6)	In annual terms	Sig. dev.	Sig. dev.
	In biennial terms	Close to sig.	Non-sig. dev.
Bad times (adjustment matrix = 0.5)	In annual terms	Sig. dev.	Non-sig. dev.
	In biennial terms	Non-sig. dev.	Yes

3.3.3 The debt reduction rule

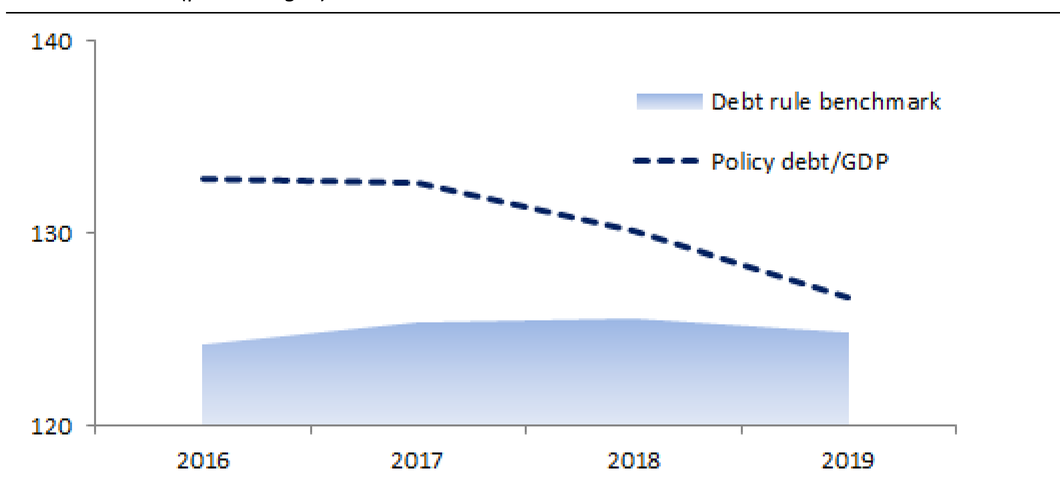
With regard to compliance with the debt reduction rule, last spring the Commission – responding to the violation of the numerical rule in 2015 – prepared a report in which it examined whether it was necessary to open an excessive deficit procedure for Italy, considering the relevant factors that may have impacted the country's debt performance. On that occasion, the European Commission decided to prepare a new report in the autumn of this year once the Government had specified the details of the budget package for 2017. If developments in the policy structural balance, one of the relevant factors, were found to be inconsistent with the EU rules, the assessment of Italy's position could be revised.

For 2016-2019, the 2017 DBP confirms that the policy targets for the debt/GDP are not consistent with compliance with the numerical rule using the three criteria provide for in European law (backward-looking, forward-looking and adjusted for the cycle; Figure 3.1).

Compared with the EFD, in the DBP the gap between the policy level of the ratio and the benchmark for compliance with the numerical rule has increased substantially. For 2019, the DBP puts it at 1.8 percentage points of GDP, compared with a gap of just 0.2 percentage points in the policy projections of the EFD.

The violation of the debt reduction rule does not automatically trigger an excessive deficit procedure by the European Commission. Before that can happen, the relevant factors must be considered. The Update in September noted those that had received a positive assessment by the Commission in its report the previous spring, which was prepared in response to the violation of the numerical rule in 2015. These included unfavourable macroeconomic conditions, especially very low inflation.

Fig. 3.1 – 2017 DBP targets in the light of the debt reduction rule
(percentages)



Source: based on 2017 DBP data.

3.4 The sustainability of the public debt

As emphasised in previous PBO reports, it is essential to assess the medium/long-term sustainability of the public debt as a proportion of GDP in the Government's policy scenario. It is important to determine whether sustainability is maintained even considering the main risk factors that could impact the ratio.

The sustainability exercises conducted here – involving a deterministic analysis and a stochastic analysis – suggest that even with less favourable macroeconomic assumptions, the public finance targets of the DBP should still ensure, with a relatively high probability, a decline in the debt/GDP ratio over the medium term. It is important to emphasise, however, that the relatively favourable scenario for the debt in the baseline projection depends considerably on the assumption of large primary surpluses as from 2019 that would enable compliance with the budget balance rule in the medium term.

3.4.1 Deterministic analysis

The policy path for the debt/GDP ratio delineated in the 2016 DBP is extended beyond 2019 until 2025 on the basis of a number of ad hoc assumptions to determine the baseline scenario.

The assumptions include: 1) the gradual convergence of real growth to 1 per cent, of the inflation rate to 2 per cent and of the short-and long-term interest rates to 3 per cent and 4.5 per cent, respectively; 2) a primary surplus sufficient to ensure overall budget balance; 3) a nil stock-flow adjustment. The extrapolation is conducted using a method similar to that adopted by the European Commission to analyse the sustainability of the public debt.[43]

With these assumptions, the baseline scenario would result in the continuation of the decline in the debt/GDP ratio after 2019; in 2025 it would still be over 100 per cent, however (Figure 3.2, panel A).

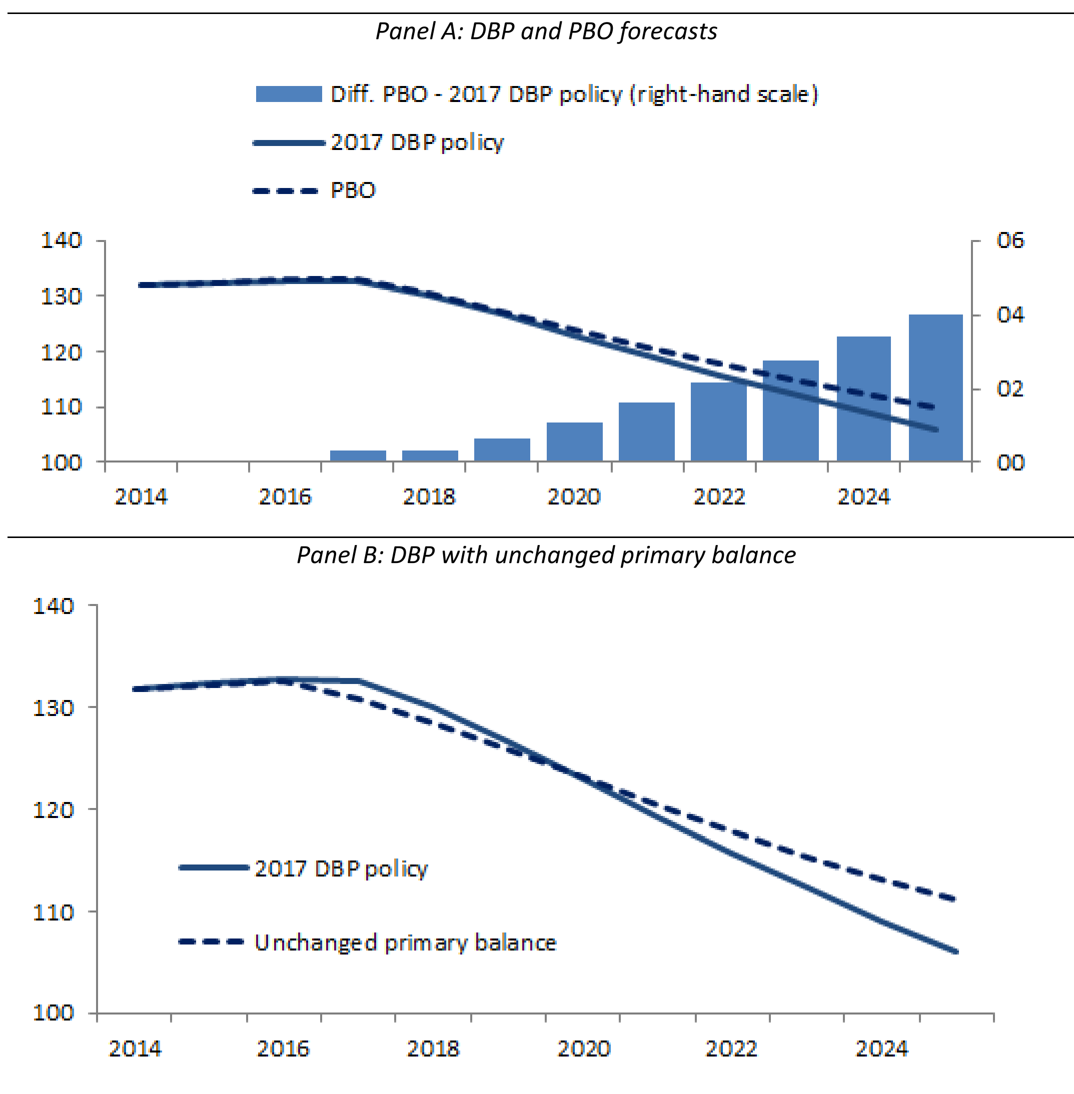
If the developments in the debt/GDP ratio are analysed together with the PBO's macroeconomic forecasts for 2017-2019, the ratio continues to decline over that period, albeit at a slower pace. The divergence between the PBO trajectory from that in the DBP would be about one percentage point in 2018, growing to nearly 4 percentage points in 2025.

The elasticity of the primary surplus/GDP ratio to growth is real GDP is assumed to be 0.539, in line with that estimated and used by the European Union. In addition, a change in the inflation rate is assumed to translate partially to interest rates. The stock-flow adjustment is unchanged compared with that in the DBP policy scenario. After 2019, the hypotheses used in the baseline scenario are retained.

[43] See the technical appendix for details on the approach.

For the purpose of ensuring the sustainability of the debt, the importance of resuming the adjustment path towards the MTO (i.e. a relatively large primary surplus in the medium term that would enable compliance with the budget balance rule) is underscored by the analysis of the impact on the debt/GDP ratio of no change in the structural primary balance from its 2016 level (Figure 3.2, panel B). This assumption would produce a slightly larger structural primary surplus than the policy surplus envisaged in the DBP for 2017, an equal surplus in 2018 and a smaller surplus in subsequent years. In this scenario, the debt/GDP ratio would fall slightly faster than the pace envisaged in the baseline scenario until 2019. The pace of decline would slow significantly in subsequent years. The debt/GDP ratio would essentially stabilise at a high level, slightly over 110 per cent, at the end of the forecasting period.[44]

Figure 3.2 – Developments in the debt/GDP ratio in different macroeconomic scenarios



Source: PBO estimates and analysis based on 2017 DBP data.

[44] In this sensitivity analysis, the fiscal multiplier is set at 0.75.

3.4.2 Stochastic analysis

In order to account for the uncertainty of forecasts of the variables that determine the debt/GDP ratio, DBP scenario has also been analysed within the context of intervals obtained using statistical techniques in line with those used by the European Commission and the International Monetary Fund.[45] More specifically, we have estimated 5,000 possible trajectories for the debt/GDP ratio, considering developments in the ratio that are consistent with the PBO macroeconomic forecasts discussed in the previous section. This enable the construction of a probability cone under an assumption of temporary (Figure 3.3, panel A) and permanent shocks (Figure 3.3, panel B) to the variables that affect the behaviour of the debt.

Using the equation that describes developments in the debt, the alternative scenarios for the debt/GDP ratio were obtained by shocking the variables used in the equation: real GDP growth rate, GDP deflator growth rate, short-term interest rate and spread between short- and long-term interest rates.[46]

With these assumptions, as shown in Figure 3.3, the policy debt/GDP ratio in the DBP is located in the lower portion of the central part of the probability cone (following the line that marks the fortieth percentile) for both temporary shocks and permanent shocks. Thus, according to this analysis the probability that the debt will evolve along the lines set out in the baseline scenario is around 40 per cent.

Using this stochastic analysis, Figure 3.4 shows the probability, in each year, of a reduction in the debt from its level the previous year (panel A) and of compliance with the debt reduction rule using the backward-looking criterion (panel B) under the assumptions of temporary and permanent shocks. The analysis reveals that the probability of a decline in the debt/GDP ratio is just under 50 per cent in 2017, while the likelihood of a reduction in the ratio is equal to or greater than 95 per cent in 2019-2020. In the case of permanent shocks, the probability of a decline falls in the medium term but remains high, at between 85 and 90 per cent.

By contrast, with regard to the backward-looking debt rule, the analysis finds a very low probability of compliance in the short term, at less than 20 per cent. The probability of compliance with the rule rises in subsequent years in both scenarios, but is still only slightly more than 40 per cent in the medium term.

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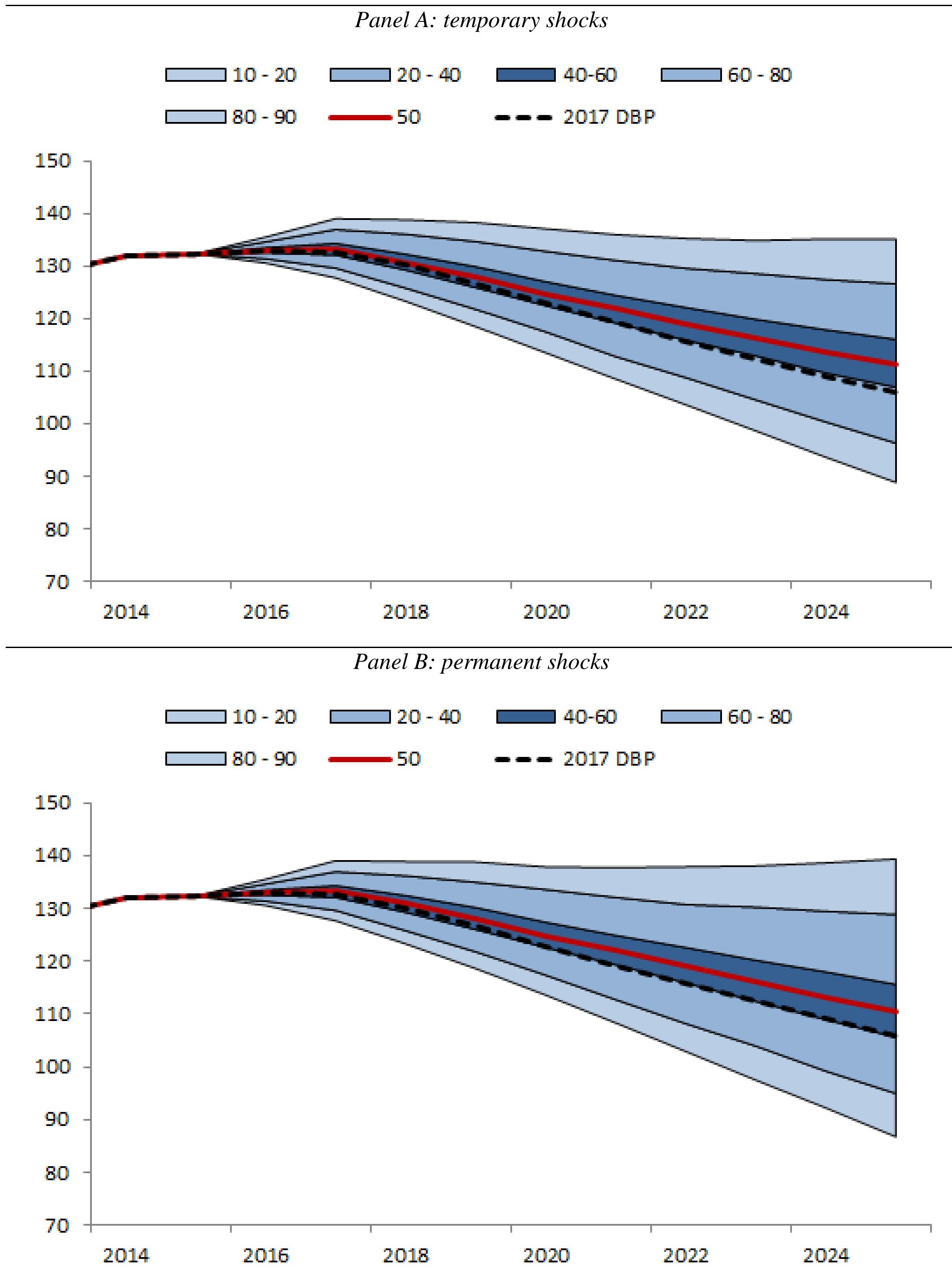
[45] See Berti K. (2013), "*Stochastic public debt projections using the historical variance-covariance matrix approach for EU countries*", *European Commission*, *Economic Papers 480*, *April*.

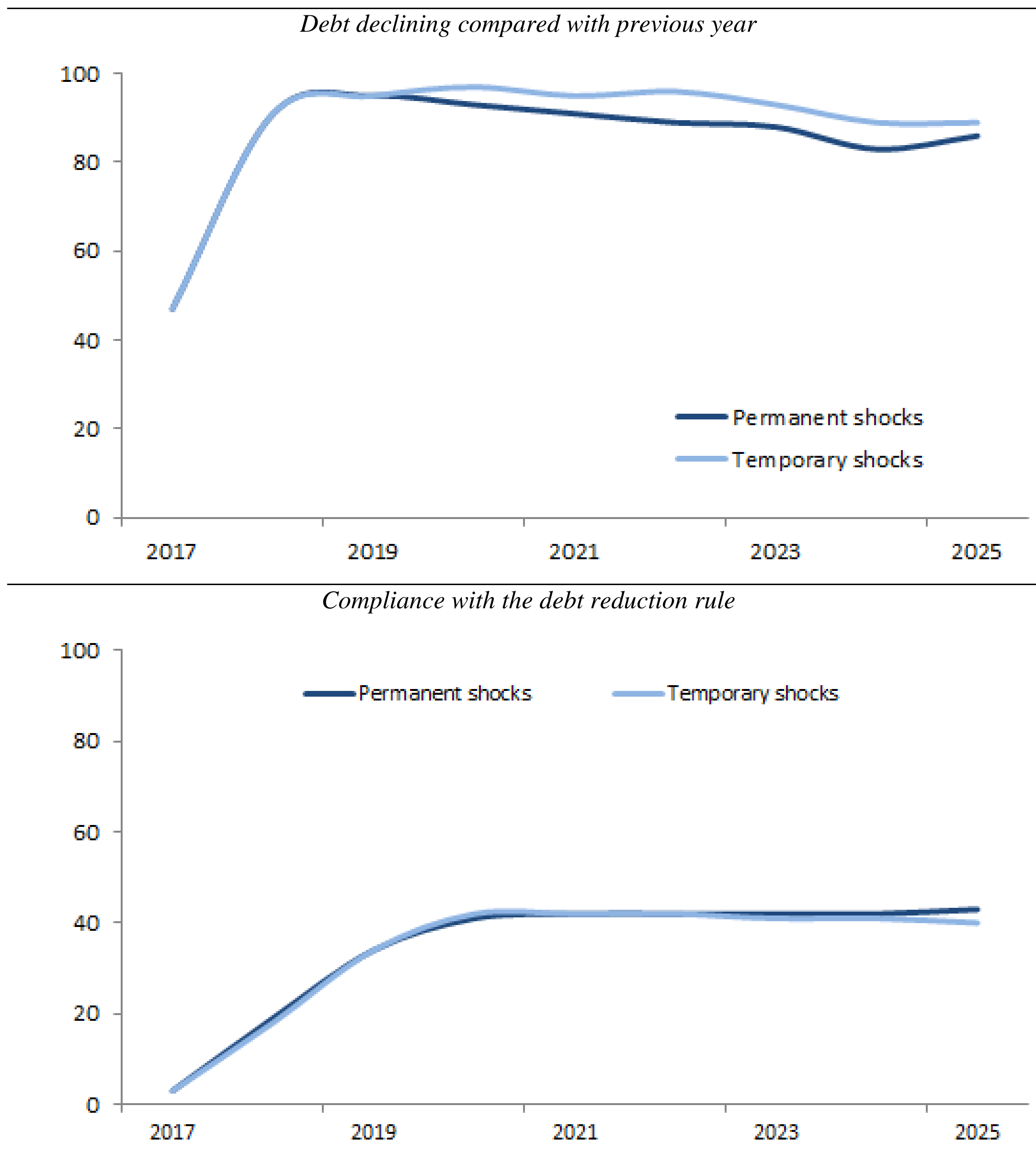
[46] The assumption of temporary shocks envisages changes in the variables that determine developments in the debt/GDP ratio with an impact limited to the year in which the shocks occur. The assumption of permanent shocks envisages persistent shocks with regard to interest rates. For 2016, the variables were exposed to a shock for the second half of the year only, given that the figures for the first half were already known.

Figure 3.3 – Stochastic analysis with temporary shocks: 2017 DBP policy scenario compared with PBO scenario



Source: PBO estimates and analysis based on 2017 DBP data.

Figure 3.4 – Stochastic analysis with temporary shocks: implicit probabilities



Source: PBO estimates and analysis based on 2017 DBP data.

Appendix 3.1

The targets in the 2017 DBP in the light of the structural balance rule in different scenarios

This appendix contains tables with the items necessary to assess the consistency of the 2017 DBP targets with the structural balance rule. The tables differ in the assumption concerning the required adjustment. Table A3.1.1 assumes that in 2017 economic conditions are considered normal (required adjustment excluding flexibility clauses and exceptional events equal to 0.6) and no events are considered exceptional. Table A3.1.2 differs from the previous one in that it assumes that the flow of refugees and the earthquakes are recognized as exceptional events in 2017 for which the Government has estimated expenditure of 0.4 points of GDP. Tables A3.1.3 and A3.1.4 respectively present the results obtained with and without recognition of exceptional circumstances in 2017 in the case where economic conditions are considered bad (required adjustment excluding flexibility clauses and exceptional events equal to 0.5).

Table A3.1.1 – 2017 DBP targets in the light of the structural balance rule – Normal times and no exceptional events in 2017
(percentage points)

Structural balance - 2017 DBP	**-0.7**	**-1.2**	**-1.6**	**-0.7**	**-0.2**
Required adjustment excluding clauses (annual) (a)	0.25	0.5	0,6 (1)	0.6	0.6
Deviation for structural reform and investment clauses (b)	0.0	0.75	0.0	0.0	0.0
Deviation for exceptional events (c)	0.03	0.1	0.0	0.0	0.0
Required adjustment including clauses and exceptional events (d=a-b-c)	0.22	-0.35	0.6	0.6	0.6
Adjustment achieved (annual) (e)	0.2	-0.5	-0.4	0.9	0.5
Difference between adjustment achieved and required (annual) (f=e-d)	-0.1	-0.2	-1.0	0.3	-0.1
Compliance with adjustment path towards MTO (annual) (2)		**Non-sig. dev.**	**Sig. dev.**	**Yes**	**Non-sig. dev.**
Required adjustment including clauses and exceptional events (two-year average) (g)		-0.07	0.13	0.60	0.60
Adjustment achieved (two-year average) (h)		-0.19	-0.47	0.25	0.70
Difference between adjustment achieved and required (two-year average) (i=h-g)		-0.13	-0.60	-0.35	0.10
Compliance with adjustment path towards MTO (two-year average) (3)		**Non-sig. dev.**	**Sig. dev.**	**Sig. dev.**	**Yes**

Source: based on 2017 DBP data.
(1) For 2017 the required adjustment is that applicable to Italy in “normal” economic conditions, as requested by the EU Council last July. – (2) On an annual basis, the deviation is considered significant if it exceeds 0.5. – (3) On a two-year basis, the average deviation in the two years is considered significant if it exceeds 0.25.

Table A3.1.2 – 2017 DBP targets in the light of the structural balance rule – Normal times and recognition of exceptional events in 2017
(percentage points)

	2015	2016	2017	2018	2019
Structural balance - 2017 DBP	**-0.7**	**-1.2**	**-1.6**	**-0.7**	**-0.2**
Required adjustment excluding clauses (annual) (a)	0.25	0.5	0,6 (1)	0.6	0.6
Deviation for structural reform and investment clauses (b)	0.0	0.75	0.0	0.0	0.0
Deviation for exceptional events (c)	0.03	0.1	0.4	0.0	0.0
Required adjustment including clauses and exceptional events (d=a-b-c)	0.22	-0.35	0.2	0.6	0.6
Adjustment achieved (annual) (e)	0.2	-0.5	-0.4	0.9	0.5
Difference between adjustment achieved and required (annual) (f=e-d)	-0.1	-0.2	-0.6	0.3	-0.1
Compliance with adjustment path towards MTO (annual) (2)		**Non-sig. dev.**	**Sig. dev.**	**Yes**	**Non-sig. dev.**
Required adjustment including clauses and exceptional events (two-year average) (g)		-0.07	-0.07	0.40	0.60
Adjustment achieved (two-year average) (h)		-0.19	-0.47	0.25	0.70
Difference between adjustment achieved and required (two-year average) (i=h-g)		-0.13	-0.40	-0.15	0.10
Compliance with adjustment path towards MTO (two-year average) (3)		**Non-sig. dev.**	**Sig. dev.**	**Non-sig. dev.**	**Yes**

Source: based on 2017 DBP data.
(1) For 2017 the required adjustment is that applicable to Italy in "normal" economic conditions, as requested by the EU Council last July. – (2) On a one-year basis, the deviation is considered significant if it exceeds 0.5. – (3) On a two-year basis, the average deviation in the two years is considered significant if it exceeds 0.25.

Table A3.1.3 – 2017 DBP targets in the light of the structural balance rule – Bad times and no exceptional events in 2017
(percentage points)

	2015	2016	2017	2018	2019
Structural balance - 2017 DBP	**-0.7**	**-1.2**	**-1.6**	**-0.7**	**-0.2**
Required adjustment excluding clauses (annual) (a) (1)	0.25	0.5	0.5	0.6	0.6
Deviation for structural reform and investment clauses (b)	0.0	0.75	0.0	0.0	0.0
Deviation for exceptional events (change in refugee and security expenditure 2015 and 2016) (c)	0.03	0.1	0.0	0.0	0.0
Required adjustment including clauses and exceptional events (d=a-b-c)	0.22	-0.35	0.5	0.6	0.6
Adjustment achieved (annual) (e)	0.2	-0.5	-0.4	0.9	0.5
Difference between adjustment achieved and required (annual) (f=e-d)	-0.1	-0.2	-0.9	0.3	-0.1
Compliance with adjustment path towards MTO (annual) (2)		**Non-sig. dev.**	**Sig. dev.**	**Yes**	**Non-sig. dev.**
Required adjustment including clauses and exceptional events (two-year average) (g)		-0.07	0.08	0.55	0.60
Adjustment achieved (two-year average) (h)		-0.19	-0.47	0.25	0.70
Difference between adjustment achieved and required (two-year average) (i=h-g)		-0.13	-0.55	-0.30	0.10
Compliance with adjustment path towards MTO (two-year average) (3)		**Non-sig. dev.**	**Sig. dev.**	**Sig. dev.**	**Yes**

Source: based on 2017 DBP data.
(1) For 2017 the required adjustment is that applicable to Italy in "bad" economic conditions, as determined on the basis of the estimated output gap of -1.7 in the 2017 DBP. – (2) On a one-year basis, the deviation is considered significant if it exceeds 0.5. – (3) On a two-year basis, the average deviation in the two years is considered significant if it exceeds 0.25.

Table A3.1.4 – 2017 DBP targets in the light of the structural balance rule – Bad times and recognition of exceptional events in 2017
(percentage points)

	2015	2016	2017	2018	2019
Structural balance - 2017 DBP	**-0.7**	**-1.2**	**-1.6**	**-0.7**	**-0.2**
Required adjustment excluding clauses (annual) (a) (1)	0.25	0.5	0.5	0.6	0.6
Deviation for structural reform and investment clauses (b)	0.0	0.75	0.0	0.0	0.0
Deviation for exceptional events (change in refugee and security expenditure 2015 and 2016) (c)	0.03	0.1	0.4	0.0	0.0
Required adjustment including clauses and exceptional events (d=a-b-c)	0.22	-0.35	0.1	0.6	0.6
Adjustment achieved (annual) (e)	0.2	-0.5	-0.4	0.9	0.5
Difference between adjustment achieved and required (annual) (f=e-d)	-0.1	-0.2	-0.5	0.3	-0.1
Compliance with adjustment path towards MTO (annual) (2)		**Non-sig. dev.**	**Limite sign.**	**Yes**	**Non-sig. dev.**
Required adjustment including clauses and exceptional events (two-year average) (g)		-0.07	-0.12	0.35	0.60
Adjustment achieved (two-year average) (h)		-0.19	-0.47	0.25	0.70
Difference between adjustment achieved and required (two-year average) (i=h-g)		-0.13	-0.35	-0.10	0.10
Compliance with adjustment path towards MTO (two-year average) (3)		**Non-sig. dev.**	**Sig. dev.**	**Non-sig. dev.**	**Yes**

Source: based on 2017 DBP data.
(1) For 2017 the required adjustment is that applicable to Italy in “bad” economic conditions, as determined on the basis of the estimated output gap of -1.7 in the 2017 DBP. – (2) On a one-year basis, the deviation is considered significant if it exceeds 0.5. – (3) On a two-year basis, the average deviation in the two years is considered significant if it exceeds 0.25.

Appendix 3.2

The targets in the 2017 DBP in the light of the expenditure rule in different scenarios

This appendix contains tables with the items necessary to assess the consistency of the 2017 DBP targets with the expenditure rule. The tables differ in the assumption concerning the required adjustment. Table A3.2.1 assumes that in 2017 economic conditions are considered normal (required adjustment excluding flexibility clauses and exceptional events equal to 0.6) and no events are considered exceptional. Table A3.2.2 differs from the previous one in that it assumes that the flow of refugees and the earthquakes are recognized as exceptional events in 2017 for which the estimated expenditure is equal to 0.4 points of GDP. Tables A3.2.3 and A3.2.4 respectively present the results obtained with and without recognition of exceptional circumstances in 2017 in the case where economic conditions are considered bad (required adjustment excluding flexibility clauses and exceptional events equal to 0.5).

Table A3.2.1 – 2017 DBP targets in the light of the expenditure rule – Normal times and no exceptional events
(percentages)

	2015	2016	2017
Corrected net annual expenditure growth (real)	**0.6**	**0.4**	**0.1**
Corrected net two-year average expenditure growth (real)	**-0.2**	**0.5**	**0.3**
Annual expenditure rule target growth including clauses and exceptional events	-0.4	0.8	-1.4
Deviation from annual target (% GDP) (1)	0.5	-0.2	0.7
Compliance with expenditure rule (annual) (2)		**Yes**	**Sig. dev.**
Two-year average expenditure rule target growth including clauses and exceptional events		0.19	-0.31
Deviation from two-year target (% GDP) (1)		0.13	0.25
Compliance with expenditure rule (two-year average) (3)		**Non-sig. dev.**	**Close to sig.**

(1) A negative sign means the target has been achieved (the growth in corrected net real expenditure is less than the target). - (2) Under EU rules, on a one-year basis, the deviation is considered significant if it exceeds 0.5. – (3) Under EU rules, on a two-year basis, the average deviation is considered significant if it exceeds 0.25.

Table A3.2.2 – 2017 DBP targets in the light of the expenditure rule – Normal times and recognition of exceptional events
(percentages)

	2015	2016	2017
Corrected net annual expenditure growth (real)	**0.6**	**0.4**	**0.1**
Corrected net two-year average expenditure growth (real)	**-0.2**	**0.5**	**0.3**
Annual expenditure rule target growth including clauses and exceptional events	-0.4	0.8	-0.5
Deviation from annual target (% GDP) (1)	0.5	-0.2	0.3
Compliance with expenditure rule (annual) (2)		**Yes**	**Non-sig. dev.**
Two-year average expenditure rule target growth including clauses and exceptional events		0.19	0.13
Deviation from two-year target (% GDP) (1)		0.13	0.05
Compliance with expenditure rule (two-year average) (3)		**Non-sig. dev.**	**Non-sig. dev.**

(1) A negative sign means the target has been achieved (the growth in corrected net real expenditure is less than the target). - (2) Under EU rules, on a one-year basis, the deviation is considered significant if it exceeds 0.5. – (3) Under EU rules, on a two-year basis, the average deviation is considered significant if it exceeds 0.25.

Table A3.2.3 – 2017 DBP targets in the light of the expenditure rule – Bad times and no exceptional events
(percentages)

	2015	2016	2017
Corrected net annual expenditure growth (real)	**0.6**	**0.4**	**0.1**
Corrected net two-year average expenditure growth (real)	**-0.2**	**0.5**	**0.3**
Annual expenditure rule target growth including clauses and exceptional events	-0.4	0.8	-1.2
Deviation from annual target (% GDP) (1)	0.5	-0.2	0.6
Compliance with expenditure rule (annual) (2)		**Yes**	**Sig. dev.**
Two-year average expenditure rule target growth including clauses and exceptional events		0.19	-0.20
Deviation from two-year target (% GDP) (1)		0.13	0.20
Compliance with expenditure rule (two-year average) (3)		**Non-sig. dev.**	**Non-sig. dev.**

(1) A negative sign means the target has been achieved (the growth in corrected net real expenditure is less than the target). - (2) Under EU rules, on a one-year basis, the deviation is considered significant if it exceeds 0.5. – (3) Under EU rules, on a two-year basis, the average deviation is considered significant if it exceeds 0.25.

Table A3.2.4 – 2017 DBP targets in the light of the expenditure rule – Bad times and recognition of exceptional events
(percentages)

	2015	2016	2017
Corrected net annual expenditure growth (real)	**0.6**	**0.4**	**0.1**
Corrected net two-year average expenditure growth (real)	**-0.2**	**0.5**	**0.3**
Annual expenditure rule target growth including clauses and exceptional events	-0.4	0.8	-0.3
Deviation from annual target (% GDP) (1)	0.5	-0.2	0.2
Compliance with expenditure rule (annual) (2)		**Yes**	**Non-sig. dev.**
Two-year average expenditure rule target growth including clauses and exceptional events		0.19	0.25
Deviation from two-year target (% GDP) (1)		0.13	0.00
Compliance with expenditure rule (two-year average) (3)		**Non-sig. dev.**	**Yes**

(1) A negative sign means the target has been achieved (the growth in corrected net real expenditure is less than the target). - (2) Under EU rules, on a one-year basis, the deviation is considered significant if it exceeds 0.5. – (3) Under EU rules, on a two-year basis, the average deviation is considered significant if it exceeds 0.25.

Appendix 3.3

Methodological approach to assessing the sustainability of the public debt

Definitions

This section summarises the main notation used in the following section. In addition, if not otherwise specified and excluding notation used to characterise periods of time, uppercase letters are used to denote actual variables and lowercase letters are used to denote rates of change, interest rates or variables as a percentage of GDP.

Variable	Definition
	Dynamic debt equation
d_t	Public debt as a percentage of GDP at year end
ob_t	Net borrowing as a percentage of GDP
pb_t	Primary balance as a percentage of GDP
ie_t	Interest expenditure as a percentage of GDP
sfa_t	Stock-flow adjustment as a percentage of GDP
π_t	Rate of change in GDP deflator
i_t	Average implicit cost of debt
r_t	Rate of change in real GDP
	Breakdown of debt and interest rates
$\gamma_{\mathrm{t}}^{\mathrm{s}} + \gamma_{\mathrm{t}}^{\mathrm{l}} = 1$	Percentages of short-term debt (s) and long-term debt (l)
$\gamma_{\mathrm{t}}^{\mathrm{lm}} + \gamma_{\mathrm{t}}^{\mathrm{lnm}} = \gamma_{\mathrm{t}}^{\mathrm{l}}$	Percentages of long-term debt maturing within the year (lm) and not maturing within the year (lnm)
i_t^s	Interest rate on short-term debt
i_t^{lm}	Interest rate on long-term debt maturing within the year
i_t^{lnm}	Average implicit cost of long-term debt not maturing within the year
$\mathrm{spread}_{\mathrm{t}} = \mathrm{i}_{\mathrm{t}}^{\mathrm{lm}} - \mathrm{i}_{\mathrm{t}}^{\mathrm{s}}$	Spread between long-term and short-term interest rates

Other

$\bar{x}_t$	Value of each variable in the dynamic debt equation after a temporary shock
$\bar{\bar{x}}_t$	Value of each variable in the dynamic debt equation after a permanent shock

Deterministic projections

The dynamic debt equation is given by:

$$D_t = D_{t-1} - OB_t + SFA_t$$

$$D_t = D_{t-1} + IE_t - PB_t + SFA_t$$

$$D_t = (1 + i_t)D_{t-1} - PB_t + SFA_t$$

$$d_t = \frac{(1 + i_t)}{(1 + r_t)(1 + \pi_t)} \cdot d_{t-1} - pb_t + sfa_t$$

In line with the method adopted by the Commission to analyse debt dynamics[47], interest expenditure at time t is expressed as the sum of three components. The first component (IE_t^s) is spending for interest on the short-term portion of public debt.[48] This share comprises short-term debt of the previous year that is rolled over and any new borrowing requirement emerging during the year and financed with new issues of short-term debt.[49] The second component (IE_t^{lm}) is spending for interest on long-term debt[50] maturing within the year and renewed and on any new borrowing requirement emerging during the year and financed with new issues of long-term debt. The third component (IE_t^{lnm}) is spending for interest on long-term debt that does not mature within the year.

Interest expenditure can be expressed as:

$$IE_t = IE_t^s + IE_t^{lm} + IE_t^{lnm}$$

$$\textit{Eq. 1:}\ IE_t = i_t^s \cdot \gamma_t^s \cdot D_t + i_t^{lm}\left(\gamma_t^{lm} \cdot D_{t-1} + \gamma_t^l \cdot \Delta D_t\right) + i_t^{lnm} \cdot \gamma_t^{lnm} \cdot D_{t-1}$$

[47] Berti, K. and Carone, G. (2014), "*Assessing Public Debt Sustainability in EU Member States: A Guide*", *European Economy Occasional Papers*, no. 200, August.

[48] Short-term debt means debt with an original maturity of less than one year. In our simulations, that aggregate also includes long-term floating-rate debt and long-term inflation-linked debt.

[49] Note that a negative borrowing requirement, i.e. available liquidity, would reduce interest expenditure as part of maturing debt can be financed with those resources rather than with new issues.

[50] Long-term debt means debt with an original maturity of more than one year. In our simulations, that aggregate only includes long-term fixed-rate debt, while variable-rate debt or inflation-linked debt is included in short-term public debt.

For historical data and the years covered by the DBP, the implicit interest rate on long-term debt that is not maturing is derived from *Eq. 1* as:[51]

$$Eq.\ 2:\ i_t^{lnm} = \frac{IE_t - i_t^s \cdot \gamma_t^s \cdot D_t + i_t^{lm}(\gamma_t^{lm} \cdot D_{t-1} + \gamma_t^l \cdot \Delta D_t)}{\gamma_t^{lnm} \cdot D_{t-1}}$$

In the simulation after the final year covered by the DBP, in line with the Commission methodology, we assume that the implicit rate at time t is a weighted average of the same implicit rate at time t-1 and the long-term interest rate for year t-1. After the final year of the DBP, the implicit rate is therefore given by:

$$Eq.\ 3:\ i_t^{lnm} \approx w_t \cdot i_{t-1}^{lnm} + (1 - w_t) \cdot i_{t-1}^{lm}$$

where $w_t = \frac{\gamma_t^{lnm} D_{t-2}}{\gamma_t^l D_{t-1}}$ is the share of long-term debt of the previous year that did not mature. In the years of the simulation that follow the period covered by the DBP, we assume that the residual of the series obtained with Eq. 2 and Eq. 3 remains constant at the last value observed and that residual is added to Eq. 3.

Stochastic simulations

The assessment of the sustainability of the public debt in stochastic terms consists in randomly shocking the variables that determine the dynamic debt equation (except for stock-flow adjustments) in order to evaluate the probability distribution of the evolution of the debt/GDP ratio. The method used is in line with the approach adopted by the European Commission.[52]

Shocks are applied to the real GDP growth rate, the GDP deflator growth rate, the short-term interest rate and the spread between long- and short-term interest rates. The shocks are obtained with extractions from a multivariate normal distribution with a zero mean and a correlation matrix of the quarterly variations in the variables calculated in the period 1990T1 – 2012T2.[53]

More specifically, the quarterly shocks are defined as $s_t^x = x_t - x_{t-1}$ where $x_t \in (r_t, \pi_t, i_t^s, spread_t)$. Defining with S the vector containing the shocks for all variables x with the variance-covariance matrix $Var(S) = \Sigma$, for each period t in the simulation

[51] The source for interest expenditure is Istat or the DBP, as it is for the primary balance, the real GDP growth rate and the GDP deflator growth rate. The source for short- and long-term interest rates is Banca d'Italia, *Supplementi al Bollettino Statistico "Mercato finanziario"*, while that for the public debt is Banca d'Italia, *Supplementi al Bollettino Statistico, "Finanza pubblica, fabbisogno e debito"* or the DBP. The source for stock-flow adjustments is the DBP.

[52] Berti, K. (2013), "*Stochastic public debt projections using the historical variance-covariance matrix approach for EU countries*", *Economic Papers* 480, April.

[53] The reference period used is in line with that adopted in the 2016 EFD. The European Commission indicates the start of the sample as 1981T1 in Berti (2013).

period we extract 5,000 vectors $E \sim N(0, \Sigma)$ whose components ε_t^x are the shocks for the variable x_t.

The quarterly shocks are annualised as the simple sum of the shocks in the four quarters of the year. For each shocked variable, the annual value after the shock, $\overline{x_t}$, is equal to $\overline{x_t} = x_t + \varepsilon_t^x$, where x_t denotes the value of the variable in the baseline scenario.

As regards the long-term interest rate on maturing debt, the post-shock value is defined as:

$$\overline{\iota_t^{lm}} = \left(i_t^s + \varepsilon_t^{i^s}\right) + \left(spread_t + \varepsilon_t^{spread}\right) = \overline{\iota_t^s} + \overline{spread_t}$$

In line with the European Commission approach, in addition to the scenario with temporary shocks, we also defined a scenario with permanent shocks, where the post-shock value of the short-term interest rate $\overline{\overline{x_t}}$ evolves as follows:

$$\begin{cases} \overline{\overline{\iota_{T0}^s}} = i_{T0}^s + \varepsilon_{T0}^{i^s}\text{ , } in\ the\ first\ period\text{ , } T0 \\ \overline{\overline{\iota_t^s}} = \overline{\overline{\iota_{t-1}^s}} + \varepsilon_t^{s^t}\text{ , } for\ t > T0 \end{cases}$$

This means that shocks in previous years continue to influence the short-term interest rate in each year t of the simulation period.

In this case, the post-shock value of the long-term interest rate on maturing debt $\overline{\overline{\iota_t^{lm}}}$ is defined as:

$$\overline{\overline{\iota_t^{lm}}} = \overline{\overline{\iota_t^s}} + \left(spread_t + \varepsilon_t^{spread}\right) = \overline{\overline{\iota_t^s}} + \overline{spread_t}$$

Given the current low level of interest rates, in order to prevent especially large negative shocks from pushing them significantly below zero, a floor of -0.5 per cent was set for short-term interest rates.

Finally, it is assumed that the primary balance responds to shocks to the real GDP growth rate with an elasticity of 0.539, as adopted at the EU level for estimating the structural balance.

The 5,000 vectors of variables so obtained are used to estimate the evolution of the debt/GDP ratio on the basis of the dynamic debt equation, generating the same number of trajectories. The probability cone presented in the report is constructed from the 10th, 20th, 40th, 50th, 60th, 80th and 90th percentiles of the distribution of the values of those trajectories in each year.

4. THE MAIN MEASURES OF THE BUDGET BILL AND THE TAX DECREE

The Budget Bill and the Tax Decree contain, on the one hand, a number of broad provisions to support the capitalisation and growth of firms, increase the neutrality of tax treatment with respect to the legal form of taxpayers, foster a revival of investment and counter tax evasion. On the other hand, they also contain more piecemeal measures pursuing diverse objectives that are difficult to place within a comprehensive vision (those regarding families, young people and anti-poverty mechanisms). The quantification of the measures presented in the technical reports accompanying the Budget Bill and the Tax Decree, while generally plausible, are exposed to risks, especially on the revenue side (section 2.3).

This chapter discusses the main provisions of the budget package, generally referring to the formulation of the measures contained in the Budget Bill and the Tax Decree as presented for examination.

4.1 Measures for firms

The budget includes a number of major provisions in favour of businesses. Part of these involve investment incentives (super- and hyper-depreciation, tax credit for R&D), responding this year as well to the contingent need to sustain and drive the economic recovery on the supply side. Other measures regard a revision of the structure of business income taxation (IRI, ACE) to introduce greater neutrality of tax treatment with respect to the legal status of business taxpayers. Overall, official estimates indicate that the measures will reduce the net borrowing requirement by €2.3 billion in 2017 and increase it by €1.1 billion and €3.4 billion in 2018 and 2019 , respectively (Table 4.1).

More specifically, the decreases in revenue of €3.5 billion in 2018 and €3.9 billion in 2019 are attributable to the extension and enhancement for certain types of assets of the increase in allowable depreciation introduced with the 2016 Stability Act (€1.1 billion in 2018 and €1.9 billion in 2019) and the introduction of IRI, an optional system for the taxation of the entrepreneurial income of taxpayers adopting ordinary accounting (about €2 billion in 2018 and €1.2 billion in 2019). The increases in revenue, equal to €2.5 billion in 2017 and €3.3 billion and €1.3 billion in the two subsequent years, respectively, essentially reflect the revision of the notional rates for the application of the aid for economic growth (AEG) deduction (€1.7 billion in 2017, €1.5 billion in 2018 and €1.4 billion in 2019) and the transition to a cash basis for taxpayers adopting simplified accounting. In the latter case, the measure merely brings forward the revenue in 2018 (€1.3 billion) and the effect then dissipates after the first year, even producing a reduction of €550 million in revenue in 2019.

Table 4.1 – The main measures concerning firms
(millions of euros)

	2017	2018	2019
Decreases in revenue	**0**	**-3,480**	**-3,893**
IRI - Partnerships and sole proprietorships	0	-1,986	-1,235
Increase in allowable depreciation charges and lease instalments on new capital equipment	0	-1,131	-1,923
smallholders	0	-228	-135
Facilitated allocation of assets to partners	0	-56	-49
Subsidies for start-ups owned by listed companies		-39	-61
Subsidies for investment in the capital of start-ups and innovative SMEs	0	-33	-36
Elimination of IRES surtax - investment fund management companies	0	-7	-5
Separate taxation mechanism for small enterprises	0	0	-293
Group VAT	0	0	-158
Increases in revenue	**2,456**	**3,334**	**1,344**
Change in AEG mechanism	1,706	1,527	1,423
Change in VAT rules for changes in taxable amount or tax	340	340	340
Extension of redetermination of purchase value of land and equity investments	320	160	160
Revaluation of corporate assets	60	0	-3
Extension of deadline for allocation of assets to partners	25	-26	-23
Cash-based accounting (simplified accounting system)	0	1,331	-553
Facilitated disposal of real estate from corporate assets	5	2	-1
Increases in expenditure	**148**	**921**	**839**
Refinancing of measures for self-employment	70	60	0
Refinancing of measures for innovative *start-ups*	50	50	0
Subsidy for SMEs for purchase of capital equipment (the "New Sabatini" mechanis	28	84	112
Tax credit for R&D	0	727	727
Impact on net borrowing (1)	**2,308**	**-1,067**	**-3,388**

Source: based on data from the technical report of the 2017 Budget Bill.
(1) A positive (negative) sign indicates an improvement (deterioration) in the balance.

Increase in allowable depreciation. – The Budget Bill provides for a one-year extension of the 40% increase in depreciation for investments in plant and machinery introduced with the 2016 Stability Act. With the Budget Bill, eligible purchases of plant and machinery are those carried out in the period between 15 October 2016 and 31 December 2017. The extension measure also establishes that even a payment on account (at least 20 per cent) by the end of 2017 is sufficient, although payment must be completed by 30 June 2018. At the same time, the provisions restrict the eligibility of investment in transport equipment, which must be use for the purposes of the business. They also increase the benefit from 40 to 150 per cent for a specific category of very high tech capital goods (industry 4.0). Finally, for those making investments in this latter category, the increase of 40 per cent is also extended to purchases of business-related intangible assets, such as software used to drive the transition towards technological innovation.

This type of incentive represents a sort of grant for the purchase of capital goods equal to 40 per cent (150 per cent for specified assets) of the expenditure, distributed proportionately over the useful life of the asset and disbursed in the form of tax savings and is thus dependent on the fiscal capacity of the firm.

Firms that carried out investments in the last three months of 2015 and in 2016 will enjoy, in 2017 and the coming years (until the end of the useful life of the asset), tax savings that the technical report of the 2016 Stability Act had quantified in cash terms at €0.9 billion in 2017 and €1.3 billion thereafter. The technical report of the Budget Bill estimates the extension of the incentive in 2017, in its revised form, will produce addition tax savings of €1.1 billion in 2018, €1.9 billion in 2018 and €1.6 billion in 2019.

The quantification used the same method adopted for the original version of the incentive. In particular, the reference base used to estimate subsidised investments in 2017-18 is the amount, assumed last year, of investments in plant and machinery in all sectors, with the exception of general government, in 2014, equal to €80 billion (the figure reported in Istat statistics). Of these €80 billion, it is assumed that €5 billion of the €12 billion in investment in transport equipment (the source is again Istat 2015) will no longer qualify for the subsidy and €10 billion will qualify for the 150 per cent increase in allowable depreciation. These will be accompanied by €2 billion in investments in intangible assets with the 40 per cent increase (according to the projections of the Ministry for Economic Development).

Similarly to last year, the depreciation and amortisation charges are defined on the basis of an average useful life of the corresponding assets of seven years, and the tax savings are calculated using an average IRES/IRAP rate of 17.45 per cent. Furthermore, the distribution of cash receipts does not use the forward-looking method. Useful life is however reduced to five years for the share of investment allocated to transport equipment and high-tech capital goods, and three years for software. Although only a partial solution, this distinction makes it possible to take account of the time profile of the loss of revenue more satisfactorily.[54]

The quantification described in the technical report uses a number of less-than-conservative assumptions.

An initial case regards the estimate of the amount of new subsidised investment, which also differs with respect to the *ex-ante* quantification for the existing subsidy. It was noted that this investment incentive was introduced at a particular stage of the economic cycle, as companies had significantly reduced their volume of investment in a contraction under way since 2007 (Table 4.2). New aggregate data published by Istat this year show developments in investment by type of asset updated to 2015. The overall performance of investments shows the same decline that was observed last year continuing up to 2014, although in that year the value of non-financial investments (excluding general government) was revised upwards from €80 billion to almost €83 billion. But in 2015, total investment increased by 1.5 per cent, with a faster acceleration for investments benefiting

[54] While a more detailed analysis is provided in PBO Working Paper no. 1 of January 2016, note that the quantification method was based on an aggregate assessment of subsidised investment and an average useful life of seven years that did not take account of differences in the useful lives of different assets: the temporal distribution of the loss of revenue was therefore underestimated in the early years of application and overestimated subsequently.

from the subsidy mechanism (4.7 per cent), especially transport equipment (19.4 for cent), producing a total of about €87 billion. This performance would reduce tax revenue by more than initially planned (calculated on the basis of total investment of €87 billion instead of the €80 billion used in the technical report) not only for the subsidy already in place for investments carried out in 2015, but also for the reference base for subsidised investment in 2016 and in 2017, under the still conservative assumption that companies continue to invest the same amount as they did in 2015, with no further acceleration.

A second, less significant, aspect regards as the estimation of lost revenue for intangible assets, for which investment spending is assumed to be equal to €2 billion, corresponding to slightly more than 10 per cent of the figure reported by Istat for the overall spending on software and databases (excluding general government), which amounted to €19 billion in 2014.

Using the latest Istat statistics, while retaining the conservative assumption that only 50 per cent of investments in software would be eligible for the facilitated treatment, the loss of revenue would be underestimated by almost 20 per cent (around €200 million in 2018 and €400 million in 2019, on a cash basis).

The tax on entrepreneurial income (IRI). - IRI is a proportional taxation system on the undistributed income of sole proprietorships and partnerships.[55] The IRI rate is 24 per cent, in line with that levied with IRES on the income of corporations.[56] Income distributed by entrepreneurs, for income subject to IRI, is excluded from the IRI tax base and remains taxed at the progressive personal income tax rate in order to avoid double taxation. The limit on the deductibility of amounts distributed is equal to the sum of undistributed earnings in the current year and the earnings (net of deducted losses) subject to IRI in previous years.

Table 4.2 – Developments in gross fixed investment (2008-2015)
(annual percentage change)

	2008	2009	2010	2011	2012	2013	2014	2015
Total investment (non-financial assets)	**-0.1**	**-9.3**	**1.8**	**0.6**	**-8.0**	**-6.6**	**-2.7**	**1.5**
Plant, machinery and arms	-2.0	-14.6	7.3	1.4	-11.0	-8.3	1.5	4.7
Transport equipment	3.2	-21.7	-2.0	5.6	-26.7	-22.3	12.0	19.4
ICT equipment	-5.6	-16.3	19.0	1.0	-4.2	-3.7	-2.9	2.8
Computer hardware	*-7.1*	*-20.9*	*12.0*	*-2.0*	*-6.7*	*-2.6*	*5.5*	*2.7*
Telecommunications	*-3.9*	*-11.3*	*25.8*	*3.6*	*-2.2*	*-4.6*	*-9.6*	*2.9*
Other plant, machinery and equipment	-2.9	-12.3	8.1	0.4	-8.2	-6.2	0.4	2.3
Other investment	0.9	-6.6	-0.8	0.2	-6.4	-5.8	-4.6	-0.1

Source: based on Istat data, 2016.

[55] A similar tax system already existed in Italian law. It was introduced with Law 244/2007 (Art.1, paragraphs 40, 41 and 42), but it did not enter into effective force as the implementing decrees were never issued. The tax enabling law (Law 24 of 2014) then provided for the introduction of a proportional tax on entrepreneurial income, which should have been extended to the self-employed (arts and professions). Here too, the enabling legislation (now lapsed) was never implemented.
[56] The 2016 Stability Act reduced the IRES rate to 24 per cent for 2017, from the previous 27.5 per cent.

The measure seeks to remove the existing disparity in treatment between unincorporated businesses and corporations, making the tax system more neutral with respect to the choice of business status. At the same time, by reducing the taxation of reinvested profits, the measure also seeks to bolster the capitalisation of enterprises with own funds.

Retained earnings that are reinvested in a sole proprietorship or simple partnerships are in fact subject to a higher tax burden than corporations. These amounts, although they does not directly contribute to the entrepreneur's ability to pay, are currently taxed progressively through personal income tax, rather than at a proportional rate. Figure 4.1 shows the magnitude of the difference in tax treatment of retained earnings in the progressive system compared with the IRES proportional system with a tax rate of 24 per cent. The tax differential is expressed as a percentage of retained earnings. The penalty emerges for incomes over €15,000 and, for equal shares of retained earnings, rises as income increases, reaching an overall differential of 19 percentage points of tax for the highest incomes. For a given level of entrepreneurial income, the additional tax is lower as the share of earnings retained increases. Moreover, in addition to the data reported in Figure 4.1, the personal income tax system also levies municipal and regional surtaxes on income.

Finally, it should be noted that the IRI regime enables businesses to “smooth” distributed income in the presence of irregular revenue,[57] a phenomenon that specifically regards the recipients of income from entrepreneurial activities, unlike employees. This would enable tax savings due to the lower concentration of distributed income, subject to a progressive tax rate, thereby reflecting the actual ability to pay of the recipient of irregular income flows more precisely over a time horizon of more than year.

The new regime is optional, so the actual use of IRI and the impact on the public finances will depend on entrepreneurs’ assessment of its advantages. Once the choice is made, the new regime will also cover the share of income not distributed and left in the business.

From the point of view of the tax benefit in a single tax year, the new system lowers the tax burden if the portion of the taxable income of partners leave in the business (undistributed) would be taxed at a marginal personal income tax rate of more than 24 per cent. Since the lowest Irpef (personal income tax) rate (applicable to the first €15,000 of income) is 23 per cent, and this is increased by regional and municipal surtaxes, it is immediately clear that in most cases the greatest theoretical tax benefit could be obtained by leaving all income in the business.

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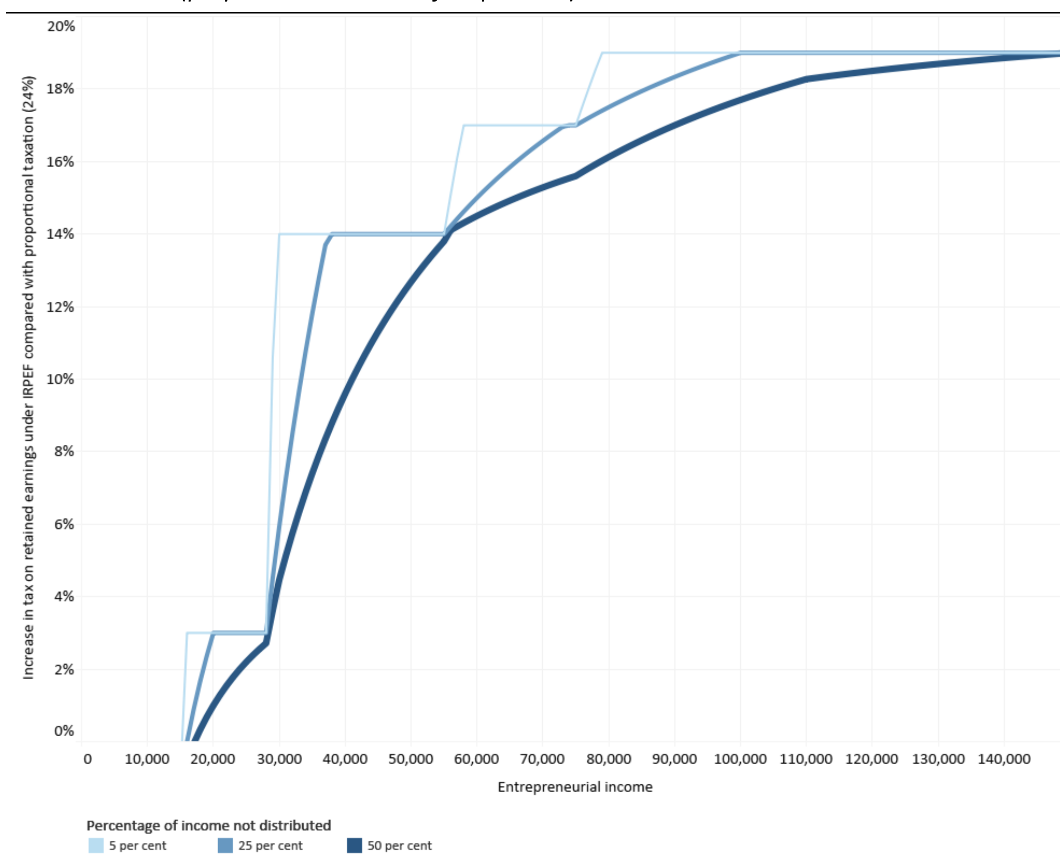
[57] In years in which revenue is relatively higher, the entrepreneur could find it advantageous to leave the money in the business, paying a lower proportional tax rate than the progressive rate on personal income, to then distribute the income later during less favourable economic conditions (paying a lower progressive tax rate because it is calculated on a lower income).

Figure 4.1 – Difference in the tax treatment of undistributed earnings under a progressive tax system compared with a proportional system. Analysis on the basis of entrepreneurial income and the share of retained earnings *(proportional tax rate of 24 per cent)*



The official figures point to a scenario in which decisions about the distribution of profits are strongly influenced by the tax savings achievable under the IRI system. The technical report assumes that entrepreneurs will leave the majority of their income in the business, withdrawing only a credible minimum income for the purpose of the income assessment system (*redditometro*).[58] Under these assumptions, when fully implemented the IRI system will generate a total cost for the public finances of around €430 million for sole proprietorships and €800 million for partnerships, for a total estimated cost of about €1.2 billion.

However, this assumption may be too extreme considering that an entrepreneur who left in a large proportion of income in the business would experience some difficulty in withdrawing it in the future. While the money left in the company could represent an alternative to the use of debt financing (thereby reducing interest expense, net of the associated tax savings), the entrepreneur will have to bear in mind the fact that the "concentration" of the distribution of retained profits, subject to a progressive tax rate

[58] It is assumed that the amount distributed could exceed the minimum level only for firms with higher equity-to-debt ratios (above 33 per cent), up to the level that maximises the tax savings.

at the time of distribution, could result in being taxed at a higher marginal tax rate. The higher taxes resulting from this mechanism could more than offset the savings achieved through the application of IRI. It is therefore likely that firms will elect to distribute a larger share of earnings than would produce the maximum tax savings, and therefore recourse to the IRI system could be smaller than assumed by the technical report. In this case, the costs estimated by the government could be overstated.

On the other hand, it is also possible that the cost forecast in the technical report is an underestimation, considering that the pool of potential beneficiaries is potentially larger than the sole proprietorships (and partnerships) that currently operate under the ordinary accounting system. More specifically, there are no regulatory restrictions that would prevent sole proprietorships operating under simplified accounting to opt for the ordinary accounting system and then elect to apply the IRI regime. Although the entrepreneurs currently using simplified accounting have lower incomes on average than those in the ordinary accounting system, they are many more of them (1.8 million, compared with about 150,000 under ordinary accounting). A large-scale shift to the IRI system could significantly increase the costs arising from the introduction of IRI compared with the estimate in the technical report.

To provide a basis of comparison, a number of simulations were conducted using the PBO’s tax-benefits microsimulation model for households to assess the possible costs arising from migration to ordinary accounting and subsequent adoption of the IRI system by taxpayers currently using simplified accounting. Applying similar behavioural assumptions to those used in the technical report and assuming no costs for moving ordinary accounting, we estimated that the overall cost would be approximately €0.9 billion, about twice the cost attributable to the IRI option for entrepreneurs using ordinary accounting today.

AEG. – The revision of deductions under the aid for economic growth mechanism (AEG) impacts all firms regardless of their legal form. More specifically, a number of changes have been made to the ACE rules both to rationalise the system (also in light of the new system of business taxation provided for in the budget legislation) and to adjust them to developments in market conditions.

In order to enhance the neutrality of taxation with respect to the financing decisions of corporations, the AEG system allows the deduction of a percentage of an increase in equity capital, in the form of ordinary remuneration of capital (opportunity cost), in order to compensate for the corresponding deductibility of interest on debt capital. The ordinary return on capital is set on the basis of a notional rate of return that, under current legislation, applies to increases in capital as from 31 December 2010 for corporations (and to total shareholders' equity at end of each year for payers of personal income tax). The notional rate of return was initially set at 3 per cent, before increasing to 4 per cent and 4.5 per cent in 2014 and 2015 respectively and 4.75 per cent in 2016.

The Budget Bill includes a number of anti-avoidance rules addressing the treatment of excess deductible amounts, the equalisation of the calculation method for individual

taxpayers with that for corporations, the exclusion from the increase in capital of holdings of securities other than equity investments (for companies other than banks and insurance companies), and the repeal of the super-AEG regime, which as from 2015 allowed listed companies to increase the value of capital increases by 40 per cent (the repeal had no impact because the provision was subject to prior authorisation by the European Commission and was never actually implemented). Finally, the notional rate of return has been reduced from 4.75 per cent to 2.3 per cent in 2017 and to 2.7 per cent as from 2018, with the aim of bringing the notional rate closer to actual returns on the financial markets. Quantifying the mechanism is highly complex and is not determined by the mere change in the rate. The technical report is therefore based on a number of assumptions and the use of a microsimulation model built with the tax information of individual firms and generates only the final result on an accruals and cash basis. Without quantitative information on even just the effects of the individual provisions, its overall consistency remains difficult to assess.

In qualitative terms, note should be taken of the importance of the exception provided for in the taxpayer's charter for taxpayers other than banks and insurance companies, who for the 2016 tax period must already exclude any increase in securities holdings other than equity investments from the calculation of the increase in capital compared with the financial statements for the financial year under way at 31 December 2010. This new, more restrictive, calculation of the basis for determining the AEG deduction provides not only for the exclusion of increases in these securities in the coming years, but also the cumulative rise for each of the previous five years (disqualifying the tax advantages of past years). In addition, it is applied for the entire current year on the basis of a less favourable rule adopted almost at year end.

In quantitative terms, the exception already generates a significant increase in the tax burden in cash terms in 2017 for the firms affected (€1.7 billion), when we sum the effects of the larger balance due for 2016 (€0.4 billion) and the effects of the increase in payments on account, totalling €1.3 billion, due on that increased balance and on the forecast tax due in 2017 as a result of the other changes in the AEG mechanism (as provided for in the bill).

Using the PBO's simulation model for the income tax of non-financial corporations, based on financial statement data drawn from the CERVED database (as the micro-data from IRES returns are not available), we estimated the pure impact on tax revenue from corporations of the interaction between the reduction in the IRES rate already legislated in the 2016 Stability Act and the changes in the AEG mechanism envisaged in the Budget Bill. In general terms, the 3.5 point reduction in the corporate income tax rate lowers the tax liability by 12.7 per cent for all types of firm. Both changes to the AEG mechanism that impact corporations (reduction of the notional rate return and the restriction of the reference aggregate used in calculating the relief) tend to increase the IRES liability and are less evenly distributed among the different types of firm (Table 4.3). The elimination of increases in the securities holdings of non-bank and non-

insurance companies from the calculation of the expansion of equity capital - which is intended to focus the incentive on productive injections of capital – increases the tax liability by less than 2 per cent, with a larger rise for industry and, in services, for holding companies.[59]

The reduction in the notional rate of return (from 4.75 per cent to 2.3 per cent) increases the tax liability by an average of 1.8 percentage points. The impact is larger in sectors that have increased capital by a relatively larger amount, such as firms in agriculture and holding companies. The overall impact of these measures generates a tax savings of 10.8 per cent, with smaller savings in sectors that have increased capital or purchased securities other than equity investments by more than average.

Examining the impact by firm size, excluding holding companies,[60] the overall net tax savings are broadly uniform, varying from between 11 and 11.5 percentage points (Table 4.4).

The relatively largest savings are achieved by smaller firms, which are less impacted by the reorganisation of the AEG mechanism because they lag relatively far behind in rebalancing their sources of funds. Smaller companies make little use of the AEG mechanism,[61] with a very low average level of equity capital and relatively little recourse to purchases of securities other than equity investments. As a result, the tax savings are relatively higher, even though in absolute terms the aggregate IRES savings for this segment of firms represent only 3.2 per cent of the total.

Table 4.3 – *Analysis of the effects of the reduction in the IRES rate and AEG changes by firm sector*
(percentages)

	Composition of potential AEG deduction	Composition of IRES on 2016 current legislation basis	Impact of reduction in IRES rate (from 27.5% to 24%)	Impact of sterilisation of other securities	Impact of reduction in rate of return (from 4.75% to 2.3%)	Total net impact IRES saving	Composition of net IRES saving
Agriculture	1.0	0.4	-12.7	0.1	2.9	-9.8	0.3
Industry	27.1	39.6	-12.7	0.2	1.5	-11.0	40.6
Services (1)	71.9	60.1	-12.7	0.2	2.0	-10.6	59.1
of which: holding (	*37.1*	*12.3*	*-12.7*	*0.4*	*3.5*	*-8.9*	*10.2*
Total	100.0	100.0	-12.7	0.2	1.8	-10.8	100.0

(1) Excluding banks and insurance companies. – (2) ATECO sectors 64.2 and 70.1.

[59] Holding companies involved in management activities (operational holding companies)
[60] In assessing the effects by firm size, units in the holding company sector (i.e. ATECO 2007 codes 64.2 and 70.1, were excluded, as such firms have average values that differ considerably from those of other companies. Owing to the difference in the population of firms analysed, the totals by sector (Table 4.9) and by firm size (Table 4.10) for the effect of the reduction in the tax rate and the AEG amendments do not fully coincide.
[61] Figures from the Taxpayer Database for the 2013 tax year show that only 13 per cent of the smallest firms reported an AEG deduction, compared with the average of 66 per cent for larger firms.

Table 4.4 – Analysis of the effects of the reduction in the IRES rate and the AEG amendments by firm size
(percentages)

Firms by class of value of production	Frequency	Composition of potential AEG deduction	Composition of IRES on 2016 current legislation basis	AEG deduction by firm as a ratio of average per capita deduction	Impact of reduction in IRES rate (from 27.5% to 24%)	Impact of sterilisation of other securities	Impact of reduction in rate of return (from 4.75% to 2.3%)	Total net impact IRES saving	Composition of net IRES saving
Small (< €100,000)	41.5	7.3	3.1	0.2	-12.8	0.1	1.2	-11.5	3.2
Medium (between €100,000 and €2.5 million)	52.7	20.1	21.1	0.4	-12.7	0.1	1.7	-11.0	21.0
Large (> €2.5 million)	5.8	72.6	75.9	12.5	-12.7	0.2	1.5	-11.0	75.8
Total (1)	**100.0**	**100.0**	**100.0**	**100.0**	**-12.7**	**0.2**	**1.6**	**-11.0**	**100.0**

Measures to foster investment in firms. – The Budget Bill contains tax relief measures for: 1) institutional investors (including pension funds) and collective investment undertakings (CIUs) that invest in Italian companies or European companies with a permanent establishment in Italy; 2) individuals who undertake a long-term investment plan (PIR) that includes a specified share of investment in Italian or European companies (especially small and medium-sized enterprises) with a permanent establishment in Italy. The relief consists in the total exemption from income tax of investment income, on the condition that those investments are held for at least five years. The intention is to channel savings to the real economy in order to counter the difficulties firms face in accessing credit, especially small and medium-sized enterprises.

Although the objective of the relief seems to be in line with the needs of many sectors, we should note that the creation of an additional financial vehicle (namely the PIR) could subtract resources from pension funds and similar entities, triggering a form of fiscal competition. It could also generate uncertainty in the decisions of Italian households who are becoming aware of the importance of saving for retirement. Among other things, the Budget Bill envisages incentives for "occupational welfare" in the form of contributions to pension funds and healthcare funds.

Other incentives are intended to support the investments of innovative small and medium-sized firms and start-ups. More specifically, the bill appropriates €120 million and €110 million in 2017 and 2018 respectively to refinance entrepreneurial initiatives through the Sustainable Growth Fund, which provides subsidised financing to support the creation and development of innovative start-ups. Other measures will reduce taxes by €70 million and €95 million in 2018 and 2019 respectively in order to extend and expand subsidies for investment in these firms (although these provisions are subject to clearance from the European Commission). More specifically, the IRPEF tax credit and the IRES deduction granted on a temporary basis heretofore (for 2012-2016) are made permanent and standardised at 30 per cent of amounts invested regardless of the type of beneficiary firm. The existing rules had provided for an IRPEF tax credit of 19 per cent or an IRES deduction of 20 per cent, which rise to 25 per cent and 27 per cent for start-ups operating in social or high-tech fields. In addition, the maximum amount of expenditure on which the incentive could be calculated has been raised from €500 thousand to €1 million.

The New Sabatini mechanism (Decree Law 69/2013, Article 2) has been refinanced and the tax credit for R&D investment has been extended.

The New Sabatini mechanism gives micro, small and medium-sized enterprises access (by 31 December 2016) to facilitated loans and grants for investments in machinery, plant and equipment. The loans are granted for a maximum of five years and no more than €2 million for each beneficiary firm. The bill extends the deadline for granting loans for the purchase of new machinery, plant and equipment by SMEs until 31 December 2018 and authorises expenditure of €28 million in 2017, €84 million in 2018, €112

million each year from 2019 to 2021, €84 million in 2022 and €28 million in 2023. Of those resources, 20 per cent are reserved for interest subsidies on loans for investment in technological assets (including investment in big data, cloud computing, ultra-broadband, cyber security, advanced robotics and mechatronics, augmented reality, 4D manufacturing and radio frequency identification), increased by 30 per cent of the maximum subsidy payable to an individual firm.

The tax credit for R&D investment was introduced in 2013 (Decree Law 145/2013, Article 3) and amended in the 2015 Stability Act. Under current legislation, the relief is equal to 25 per cent of incremental investment in 2015-2019 over the average for 2012-2014. In addition to extending the credit until 2020, the new rules increase the benefit (from 25 per cent to 50 per cent) and the ceiling on subsidized expenditure. They also extend the range of eligible spending and the potential beneficiaries, which now include permanent establishments of non-resident firms.

Another tax relief measure has been introduced for new firms whose owners include listed companies. In this case, even in without participation in a consolidated taxation mechanism, tax losses in the first three years after the formation of the company can be transferred and deducted from the taxable income of the controlling shareholder in exchange for monetisation of the tax benefit. While this incentive is intended to foster the creation of firms that may not produce profits initially, it could cause a greater number of economic distortions and larger-than-forecast impacts on tax revenue than assumed in the technical report, given that the relief could make tax avoidance more attractive, with the formation of new firms for the sole purpose of facilitating the tax planning of larger companies.

4.2 Measures for capital spending

A key element of the budget package is represented by measures to increase spending on capital account: net of the associated revenue measures, this component increases by €2.0 billion in 2017, €5.8 billion in 2018 and €3.6 billion in 2019 (Table 4.5).

The measures, which involve both central and local government, are directed at private and public firms and impact various sectors of the economy.

The measures in the Budget Bill (first and second section) and the Tax Decree (Decree Law 193/2016) can be grouped into three different areas of intervention.

1) One area includes a diverse group of measures that involve substantial direct public investment: about €10 billion over the three-year planning horizon.

Table 4.5 – The main capital spending measures (1)
(millions of euros)

	2017	2018	2019
Fund to be allocated for revival of investment and development of the country	629	1,968	3,500
Budget balance of local authorities - inclusion of restricted long-term fund	304	296	302
Use of surpluses and debt for investments under national solidarity pacts - local authorities	245	435	405
Regions	175	311	301
National strategic plan for sustainable mobility	0	0	200
Research for national strategic plan for sustainable mobility	2	50	50
Fund to upgrade police and firefighting equipment	20	70	100
Foundation for the implementation of the Human Technopole project	0	50	100
Increase in the ordinary fund for research agencies and institutes	0	25	25
Special capital account fund	50	150	200
Tax credit for subsidised loans for private post-earthquake reconstruction	400	500	600
Grants for post-earthquake reconstruction of public buildings	200	300	350
Extension and revision of tax credit for development and upgrading of tourism/hotel facilities (net impact)	-8	52	87
Extension and enhancement of tax credit for R&D		727	727
Grants to SMEs for purchase of capital equipment ("New Sabatini")	28	84	112
Refinancing of measures for self-employment	70	60	
Refinancing of measures for innovative start-ups	50	50	
Funding of State Railways investments - contribution to RFI programme contract (DL 193/2016)		400	
Tax credit for technology upgrade for VAT reporting (DL 193/2016)		245	
Refinancing - Section II	242	52	2
Reprogramming - Section II	29	107	
of which: financing of State Railways investments		*100*	
Other measures	98	99	44
Increase in capital expenditure	**2,541**	**5,974**	**7,138**
Reprogramming - Section II			-3,393
of which: financing of State Railways investments			*-1,400*
of which: Revolving fund for co-financing of EU policies			*-2,000*
Defunding - Section II	-442	-64	-65
of which: State Railways investments	*-320*		
of which: Reduction in expenditure of ministries and Prime Minister's Office	*-121*	*-62*	*-64*
Other expenditure reductions	-98	-98	-90
Decrease in capital expenditure (1)	**-546**	**-168**	**-3,587**

Source: based on data from the financial schedules attached to the 2017 Budget Bill (including section II) and to Decree Law 193/2016.
(1) The table does not consider the effects of the revision of telecommunication frequency usage rights, which in the schedule summarising the financial effects of the 2017 Budget Bill (AC4127) are classified under non-tax revenue, partly for the purpose of net borrowing, whereas under ESA2010 they should be included under expenditure as a reduction in capital spending.

In additional to smaller initiatives, the group includes spending by central government departments financed through the creation of an investment revival and country development fund and spending by local governments designed to exploit the amendments to Law 243/2012 on budget balance for the purpose of reviving investment (see section 4.3). More specifically, the Fund, which will be allocated with subsequent Orders of the Prime Minister on the basis of programmes prepared by

central government departments, will channel resources (in increasing amounts totalling more than €6 billion in the three-year period) to specific sectors, including: transportation and roads, infrastructure, research, land protection and hydrogeological damage remediation, public building (including schools) and earthquake resistance enhancements.

With regard to local authorities, some of the measures are intended to permit greater investment (a total of about €3.6 billion over the three years). First and foremost, these comprise those that provide for the inclusion of the restricted long-term fund (with an estimated increase in spending of about €0.3 billion a year) – which allows unused resources to be carried forward – in the reference balance for budget balance purposes. In addition, the programme also allows uncompensated expenditure (within the limits defined as part of national solidarity pacts) from the use of surpluses and debt funding (the additional expenditure is estimated at more than €0.4 billion in 2017 and more than €0.7 billion in each of the two subsequent years. The expenditure priorities include school building, earthquake resistance enhancements and the prevention of hydrogeological damage.

Among smaller programmes, a number of provisions regard the implementation of the national strategic plan for sustainable mobility, with resources (about €300 million over the three years, with most coming in 2019) for new buses in local and regional transport systems and air quality improvement initiatives, including R&D investment in alternative power technologies. Resources have also been appropriated to modernize police and firefighting equipment (about €0.2 billion) and to establish a new science foundation that will operate in a number of sectors (including healthcare and nutrition), as well as to fund research institutes supervised by the Ministry for Education, Universities and Research (for a total of €0.2 billion over the three years).

2) A second area of intervention (with total funding of about €2.5 billion over the three-year period) focuses on the seismic emergency, with resources appropriated for private reconstruction (grants for the repair and reconstruction of buildings, compensation for damage to firms' products and assets and the transfer of enterprises, using tax credits that cover part of bank financing) and public reconstruction (for reconstruction and restoration of public buildings and cultural heritage assets) in the areas hit by the earthquakes that struck in August 2016. The measures also include tax credits for the upgrading of hotel facilities, conditional on being used for renovation, seismic upgrading or energy efficiency projects.

3) The third area includes measures for firms (about €2 billion over the three years) with funding intended, as discussed more fully in section 4.1, to: expand the R&D tax credit; to extend the granting of facilitated loans for the purchase of new machinery, plant and equipment by small and medium-sized enterprises through plant grants, with increased support for investment in digital technology (the New Sabatini programme); to

encourage youth or female entrepreneurship and innovative start-ups with national and regional resources.

Within the provisions of Decree Law 193/2016 and defined in the second section of the Budget Bill for refinancing and reprogramming (more than €1 billion in the three years), the largest interventions regard financing of the State Railways for 2018 (€0.5 billion).

Reductions in capital expenditure are essentially set out in the second section of the Budget Bill. More specifically, savings are expected from reprogramming and defunding. The latter are concentrated in 2017 (more than €0.4 billion) and impact the State Railways and spending by ministries and the Prime Minister's Office. The reprogramming measures involve programmes in 2019, with the postponement of spending to subsequent years and cuts in spending through the revolving fund for co-financing of EU policies and a reduction in grants for investments of the State Railways.

The measures described – together with other revenue relief measures – are appropriate as they are targeted at reviving public and private investment spending. More specifically, in 2017-2019, public investment is allowed to increase constantly above its trend level: such spending should therefore rise faster, after the decrease in 2015 and the slight expansion expected by the Government for 2016.

Public investment contracted for five consecutive years in 2010-2014, with a cumulative decrease of more than 30 per cent compared with 2009.

It should be noted that plans call for some of the spending, on the one hand, to be devoted to the more immediate work of reconstruction after the recent earthquakes as well as more general earthquake resistance enhancements and, on the other, incorporate national co-financing of investment projects. In the Government's view, these elements should be considered for the purposes of recognition of the budgetary flexibility granted within the European rules, as discussed more extensively in section 3.1.

Finally, programmes for enterprises are a useful tool for boosting the quantity and quality of private investment, as they are also aimed at encouraging technological innovation.

4.3 Measures for local authorities

The measures in the Budget Bill and the Tax Decree regarding local authorities appear primarily aimed at supporting the spending capacity of local governments – on both current and capital account - and to support the revival of public investment through interventions at the local level (Table 4.6).

Table 4.6 – The 2016 budget package: impact on local authorities
(millions of euros; a negative sign = reduction of deficit)

	2016	2017	2018	2019
Measures with an impact on net borrowing	**100**	**1,799**	**2,088**	**2,054**
Fund to allocate among local authorities		970	970	970
Inclusion of restricted long-term fund in items used to calculate budget balance		304	296	302
Allowing expenditure for investment under nation solidarity pact - local authorities		245	435	405
Allowing expenditure for investment under nation solidarity pact - regions		175	311	301
Extension until of 2020 of regional contribution to public finances pursuant to Articles 1 - para. 680 of Law 208/2015 and 46 - para. 6 of Decree Law 66/2014 (1)				
Measures for individual authorities or groups of authorities	100	106	77	77
of which: Fund to reimburse municipalities for hosting migrants (Art. 12 DL 193/2016)	*100*			
Reimbursement of resources to Valle d'Aosta		*101*	*72*	*72*
Measures with no impact on net borrowing	**690**	**3,392**	**1,685**	**1,685**
Fund to be allocated in terms of net balance to finance (2)		1,992		
Measures for individual authorities	690	1,400	1,685	1,685
Modification of percentage participation in IRPEF Region of Sicily (3)		*1,400*	*1,685*	*1,685*
Resources for the Region of Campania for rescue of EAV (Art. 11 DL 193/2016) (4)	*600*			
Resources for the Region of Molise to cover debts to Trenitalia S.p.A. (Art. 11 DL 193/2016) (4)	*90*			

Based: summary schedules of the effects of the 2017 Budget Bill and the other measures mentioned.
(1) The amount indicated in the table is not reported in the summary schedule of the financial effects as it follows the relevant three-period. It is obtained by summing the amounts provided for in Decree Law 66/2014 charged to the ordinary statute regions only (€750 million and €3,452 million) and that provided for under Law 208/2015 charged to all the regions (€5,480 million). – (2) The summary schedule does not indicate this effect as it is offset by the reversal to revenue of remaining funds used to grant advances to local authorities to pay commercial debts and to grant loans for the restructuring of regional debts. – (3) The effect is reported in the summary schedule in terms of the borrowing requirement. – (4) Amount not indicated in the summary schedule of the financial effects at it is offset by the use of the Development and Cohesion Fund.

Exceptions include extending to 2020 the measures financed by Regions until 2019 under previous legislation - the effects of which were probably already discounted in local authority expectations - and the extension of the suspension of local tax increases for 2017, which has no impact on the public finances but could limit local governments' ability to self-finance through taxation.

With regard to the coordination of the various provisions, certain aspects of the structure of the support provided for the spending of local authorities appear inconsistent. On one hand, the legislation provides for measures to facilitate the use of past surpluses (granting of room for spending, confirming the inclusion of the restricted long-term fund and the exclusion of the provision for doubtful accounts in the calculation of local budget balances) and to discourage the formation of new surpluses (rewards for local governments that do not record any overshooting). The measures also introduce provisions that necessarily involve the creation of new surpluses (allocation of

resources from the fund in terms of the net balance to finance with a requirement to report surpluses).

Allocation of additional financial resources to local authorities. – The bill establishes two funds for local authorities in the budget of the Ministry for the Economy and Finance, specific allocation of which is entrusted to an Order of the Prime Minister to be issued by the end of January 2017. For both funds (which according to the technical report will total nearly €3 billion in 2017), in the absence of criteria for setting priorities for the appropriations and the categories of beneficiaries, the Government will decide what allocative decisions to take and what needs to meet using the available resources.[62] The absence of information makes it difficult to fully assess the impact on the public finances.

The first fund is current in nature, with a thirty-year appropriation with an annual (slightly declining) value of just under €1 billion (from €970 million in 2017 to €925 million in 2047), which has an impact on all public finance balances.

The second fund, whose status as on current or capital account is not specified, is funded with certain surpluses from previous appropriations (including funds for the granting of advances or loans to facilitate the settlement or restructuring of the liabilities of local authorities), quantified in the technical report at about €2 billion in 2017. The technical report notes that the measure does not have an impact on the public finances. For the purposes of determining the net balance to finance, the effects of the establishment of the fund would be offset by the reversal to revenue of the surpluses. For the purposes of the net borrowing requirement, the offsetting would be ensured by a provision that establishes that the beneficiaries of the fund must report a surplus equal to the amount received. Accordingly, the amounts attributed to this second fund would not give rise to an increase in spending commitments in 2017, as they would be covered by the surpluses.

The second fund, denominated “Fund to be allocated […] only in terms of the net balance to finance”, could be associated with possible risks for the public finances.

First, in 2017 the additional resources should be reported in the accounts of the local authorities as revenue on an accruals and cash basis. While entries on an accruals basis are sterilised by the recognition of the surplus, the cash-basis entries would appear to permit an increase in payments, with a potential negative impact on the borrowing requirement (not indicated in the technical report). The failure to register an impact on borrowing could be a consequence of the fact that the trend forecast already incorporates the effect on the debt of the measures to accelerate payment of liabilities from previous years, the unused surpluses for which were transferred to the fund envisaged in the Budget Bill. Moreover, no negative effects in terms of borrowing or debt were ascribed to some of these measures.[63] A clarification of the criteria for constructing the trend forecasts for these measures would therefore be helpful.

[62] For 2017, current legislation envisages considerably larger reductions in resources for the provinces and regions than those applied in 2016.

[63] The reference is to the measure in Decree Law 66/2014 that authorised the restructuring of regional debt, which was attributed a neutral impact in terms of borrowing and debt.

Second, the requirement to post a surplus, which is intended to prevent an increase in commitments in 2017, could create pressure on expenditure in subsequent years, prompting calls for flexibility in the balanced-budget requirement – similar to those for other measures in the bill – in order to use the resources locked up in the surpluses. Regardless of this latter issue, the presence of surpluses could expand the spending capacity of local authorities in compliance with the balanced-budget requirement, limiting cases of overshooting (Box 4.1).

Inclusion of the restricted long-term fund in the balanced budget constraint. – The reformulation of the balanced-budget constraint retains the inclusion of the balance on the restricted long-term fund, establishing that for 2017-2019 it shall be computed net of the share of the fund created by debt, while as from 2020 it will be limited to the part of the fund financed with final revenue.

The restricted long-term fund is an accounting tool designed to provide a degree of intertemporal flexibility to the budget, making it possible to postpone recognized revenue for works for which a budget commitment has already been made but which are payable in future years, so as to maintain financial balance between revenue and expenditure in each year. The mechanism essentially makes it possible to use revenue recognised in past years to finance investment.

The Budget Bill adopts the formulation contained in Law 243/2012 and appears to imply that the fund can be financed with resources from past surpluses only until 2019, while as from 2020 the balance-budget computation can only include fund resources deriving from final revenue posted to the fund in previous years.

The technical report attributes costs to the inclusion of the restricted long-term fund in the balanced-budget calculation only for 2017-2019, implicitly assuming that as from 2020, as surpluses can no longer be used to finance the fund, the latter will be broadly neutral for public finance purposes, with revenue and spending essentially balanced at the aggregate level. This possibility appears plausible in theory,[64] but on the operational level it is necessary to verify this assumption in reality on the basis of the actual behaviour of government entities.

[64] For an assessment of this issue, see attachment no. 1 to the text of the hearing of the Parliamentary Budget Office before the Budget Committees of the Chamber of Deputies and the Senate on 26 May 2016 on the effects of the reform enacted with Law 243/2012 on the budget balance of the regions and other local authorities.

Box 4.1 – Flexibility in use of surpluses and revenue from borrowing in compliance with the balanced budget constraint

The provision for doubtful accounts is a risk provision that must be appropriated to offset the portion of recognized revenue whose collection is uncertain (such as revenue from penalties, urbanisation fees and revenue from the fight against tax evasion). The criteria for determining these provisions is based on the ratio of receipts to recognized revenue items in the last five years. The 2017 Budget Bill, in confirming the provisions of the 2016 Stability Act, establishes that balance between final revenue and expenditure shall not take account of accruals to the provision for doubtful accounts. However, pursuant to Legislative Decree 118/2011, this does not affect the obligation to include these provisions in calculating budget balance on current account. The divergence between the two legislative measures – which gives rise to a compression of current spending, creating corresponding scope for expenditure on capital account – makes it possible to use resources deriving from surpluses (or from borrowing) created by the accruals to the provision for doubtful accounts for expenditure on investment.[65] The following is a numerical example that shows how surpluses (or resources from borrowing) can improve the use of scope for expenditure permitted by the balanced budget constraint, helping to prevent overshooting[66] (Table R4.1.1).

Table R4.1.1 – Example of use of resources from surpluses and debt in order to fully exploit financial resources under the balanced budget rule

	Scenario 1		Scenario 2		Scenario 3	
	Legislative Decree 118/2011	Law 243/2012	Legislative Decree 118/2011	Law 243/2012	Legislative Decree 118/2011	Law 243/2012
Surplus			30			
Current revenue	100	100	100	100	100	100
Capital revenue	20	20	20	20	20	20
Revenue from debt					30	
Total revenue	**120**	**120**	**150**	**120**	**150**	**120**
Current expenditure	80	70	80	70	80	70
of which: accruals to provision for doubtful accounts	*10*		*10*		*10*	
Loan repayments	20		20		20	
Capital expenditure	20	20	50	50	50	50
Total expenditure	**120**	**90**	**150**	**120**	**150**	**120**
Balance (+ = overshooting)	**0**	**30**	**0**	**0**	**0**	**0**

Scenario 1 – a local authority without surpluses or new borrowing – shows how an accounting balance of zero corresponds to imbalance under Law 243/2012, with the reporting of overshooting. This occurs when the expenditure for the accruals to the provision for doubtful accounts and for repayment of loans are recognised in the accounts but are not included in calculating budget balance, which is therefore less stringent than the accounting constraint.

Scenarios 2 and 3 show how surpluses or revenue from new borrowing cause overshooting to disappear, as it is possible to expand expenditure for investment using the increase in resources recognised in the accounts (but not in the balanced budget computation) to the extent that this is permitted by accruals to the provision for doubtful accounts and loan repayments.

[65] A similar phenomenon arises in the case of loan repayments, which are included in determining budget balance pursuant to Legislative Decree 118/2011 but are not considered in calculating the balance between final revenue and expenditure under Law 243/12, creating room for expenditure in which surpluses or resources raised through borrowing could be used.

[66] This represents achieving a better budget balance than that required by budget constraints.

Definition of a system of rewards and penalties for compliance with the balanced-budget constraint. – Of particular interest is the reward mechanism represented by the expansion of hiring authorisation (in terms of an increase in spending on personnel with flexible employment contracts for the regions and an increase from 25 per cent to 75 per cent in turnover for hiring by municipalities) for local governments that use virtually all the expenditure authority available to them under the balanced-budget constraint. The measure is intended to limit overshooting and reward authorities with better planning capabilities.

Overshooting is generally attributable to poor planning on the part of local authorities, sometime attributable to the uncertainty of actual resources available, which are often only allocated towards the close of the year. In other cases, overshooting is instead attributable to the presence of multiple constraints of diverse nature, some of which could be even more stringent than the balanced-budget restriction (Box 4.1). However, note that encouraging full use of spending authority permitted under the balanced-budget constraint (a limitation that does not take account of cash flow developments) could undermine prudence in budget planning, discouraging the reduction of previously accumulated debt.

Authorisation of financial resources for investment. – A number of measures introduce exceptions to the balanced-budget requirement in order to allow expenditure in support of investment by local authorities (€700 million, of which €300 million for school building) and the regions (€500 million). The measures allow the use of surpluses that cannot be liberated through the provision for doubtful accounts[67] and the restricted long-term fund,[68] while also permitting recourse to borrowing.

This therefore does not transfer resources to local governments but rather the permits authorities to run a deficit rather than balance their budget on the basis of amounts that will be assigned to them using the procedures envisaged under the national solidarity pact. The permissible deficit authorisation will be assigned first for school building initiatives, reducing seismic risk and hydrogeological remediation for which the local authority has produced the detailed design work, including the chronogram, financed with a surplus or, subordinately, with debt. If the overall appropriation is insufficient to meet applications, local authorities with the largest reserve fund in relation to the surplus will receive preferential treatment. In order to be granted this expenditure authorisation, the local authorities will have to report the size of their reserve fund and the surplus, net of the amount recognized in the provision for doubtful accounts.

With spending authority totalling €1.2 billion a year in the 2017-2019 period, the technical report forecasts an increase an increase in local authority spending of just €420 million in 2017, €746 million in 2018 and €706 million in 2019, using a rate for the use of spending authority estimated on the basis of previous years. As a result of the reward mechanism discussed above, it might be prudent to assume a higher rate than the historical rate. In order to assess the impact on the public finances, it would be necessary to clarify whether

[67] As they are insufficient compared with the accruals to that provision.
[68] Which can only be used to finance works that have already been earmarked.

local authorities who do not fully use their spending authorisation could possible transfer it again within the framework of regional agreements.

On the other hand, the possibility of postponing the use of unused spending authorisation to years after 2019 through the restricted long-term fund would appear to be precluded since as from 2020 only the portion of that fund financed by own revenue will be included in the balanced-budget calculation, whereas investments implemented using the spending authorisation under these rules would have to be financed through the use of surpluses or borrowing.

Measures for special-statute authorities. – With regard to special-statute entities, the Budget Bill gives the regions of Sicily and Val d'Aosta additional resources, implementing the agreements reached last summer[69] concerning joint participation in central government taxes, already implemented provisionally for 2016 only with Decree Law 113/2016.[70]

For the region of Sicily, the degree of regional participation in personal income tax revenue is redetermined, expanding the reference aggregate through the use of the criterion of "accrued" rather than "collected". This change means that the percentage of participation can be reduced from the 10 tenths provided for under current legislation while still giving the region additional resources, quantified in the technical report in terms of the net balance to be financed at €1.4 billion in 2016 and €1.7 billion a year as from 2017.[71] To offset part of this expansion, the region is required to post a surplus in 2017 of about one-third of the additional resources received (half a billion euros),[72] while no surplus is required as from 2018.[73]

The amount of resources devolved is quantified in the technical report in static terms (i.e. using the same revenue base), while the taxable amount to which the devolution is applied seems likely to evolve, owing both to nominal GDP growth and the effects of the measures to curb tax evasion.

The technical report does not indicate an impact on the general government accounts, probably assuming that the availability of additional resources for the region will not increase its expenditure capacity. This assumption presumes the existence of an underlying deficit for the region that could be covered by an increase in resources, which would prevent that deficit from occurring. The region would therefore use these resources to ensure compliance with the balanced-budget requirements rather than to increase its expenditure capacity.

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[69] On 20 June and 21 July 2016 respectively.
[70] See Articles 11 and 12.
[71] In addition to the €500 million already allocated for 2016 with Decree Law 113/2016.
[72] Similarly, for 2016, Decree Law 113 required the region to maintain a surplus of about half of the increase in resources received (€227 million).
[73] The rules also provide for constraints on the qualitative composition of the accounts in order to foster an increase in expenditure on capital account while reducing current expenditure.

The possibility that part of the resources transferred to the region of Sicily could result in an increase in spending capacity therefore represents a risk factor for the public finances.

The figures for trend developments in the public finances broken down by subsector were not reported in the Update to the 2016 Economic and Financial Document and so it is not possible to verify whether they are consistent with the implicit assumption adopted in the technical report. The criterion normally adopted by the State Accountant General in calculating trend developments is to assume full compliance with public finance constraints by all government departments.

In other measures for the special-statute regions, part of the expected increase in VAT revenue attributable to an improvement in taxpayer compliance brought about by the anti-evasion measures adopted with Decree Law 193/2016 will in all likelihood flow to the regions whose special statutes provide for a full or partial reserve of tax revenue. The technical report to that decree, which calculates the quantitative figures on the basis of an estimate of tax evasion at the national level, does not appear to consider the fact that the share of tax revenue pertaining to the special-statute regions will not be used to improve the public finance balances but rather to finance the increased spending capacity of the regions in which the revenue was generated.

4.4 Measures for pensions

The measures in the pension field introduced with the 2017 Budget Bill increase net borrowing by €1.4 billion in 2017, €2.5 billion in 2018 and €3.1 billion in 2019 (Table 4.7).[74]

Some of the measures are consistent with the general design of the pension system and do not impact its long-term sustainability (early retirement for workers who entered the labour force early and those who have physically demanding jobs, totalisation of contributions). Other measures are sectoral in nature and have welfare assistance goals (early retirement for hardship categories, the eighth safeguard measure for those who left work under an early retirement scheme but are no longer eligible for a pension following pension reform, additional pension payment scheme, etc.). The latter should be assessed in relation to the enabling legislation on the “social inclusion income” currently being discussed in Parliament. In addition, the objectives for some measures appear to overlap or even conflict with part of the regulations governing the labour market.

[74] The valuations incorporate the following induced effects: 1) an increase in the taxable income base of personal income tax as a result of the reduction in pension contributions charged to professionals not registered in specific professional associations, the abolition of penalties for those who retire before 62 (through an increase in pension payments) and the possibility of consolidating contributions made to different pension schemes; 2) a reduction in costs associated with the consolidation of pension contributions; and 3) the bringing forward of payment of termination benefits for public-sector employees as a result of the early retirement of workers in physically demanding jobs.

Table 4.7 – Pension measures
(millions of euros)

	2017	2018	2019
Increases in expenditure	**1,836**	**2,508**	**2,744**
Early retirement for hardship categories	300	609	647
Early retirement loan mechanism	70	2	8
Additional pension payment for low-income retirees	800	800	800
Consolidation of pension contributions	87	132	164
Early retirement for workers who entered the labour force early	360	550	570
Pension relief for workers in physically demanding occupations	85	86	125
Eighth safeguard measure	134	295	346
Abolition of early retirement penalties	0	34	84
Decreases in revenue	**-402**	**-501**	**-415**
No tax area for retirees under 75	-213	-247	-246
Solidarity fund for retraining of bank personnel	-174	-224	-139
Consolidation of pension contributions	-15	-30	-30
Decreases in expenditure	**-644**	**-407**	**-107**
Redefinition of expenditure for existing pension safeguard measures	-644	-407	-107
Increases in revenue	**204**	**87**	**-8**
Modification of part-time work rules for private sector	100	50	0
Temporary advance supplementary annuity (RITA)	30	14	-52
Abolition of early retirement penalties Law 214/2011 (Art. 24, para. 10)	0	11	27
Consolidation of pension contributions	4	12	17
Other	70	0	0
Impact on net borrowing (1)	**-1,390**	**-2,516**	**-3,060**

Source: based on data from the technical report of the 2017 Budget Bill.
(1) A positive (negative) sign indicates an improvement (deterioration) in the balance.

Early retirement loan mechanism and early retirement for hardship categories. – These measures are intended to increase retirement flexibility for workers approaching the retirement age. Both of these early retirement mechanisms are open to private- and public-sector workers (including those entered in the separate pension fund operated by INPS for persons not enrolled in specific professional pension funds), permitting retirement up to a maximum of 3 years and 7 months before reaching the age requirement for the old-age pension (66 years and 7 months in 2017-2018). Participation is voluntary and the mechanisms are experimental: they could be extended after 2018 if judged successful. The nature of the two mechanisms differs, however. The early retirement loan mechanism is structured as a bank loan paid in twelve monthly instalments, secured by insurance coverage in the event of premature death by a specific guarantee fund, to be repaid over 20 years through of withholdings out of future pension payments as from the time the beneficiary qualifies for the old-age pension.[75] By contrast, the early retirement scheme for hardship categories is a welfare measure, represented by a public transfer to workers in need of support. Participants in the early

[75] In addition to the age requirement, potential beneficiaries of the early retirement loan mechanism must have at least 20 years of contributions. In addition, the pension, net of the loan repayment instalment, must be equal to at least 1.4 times the minimum pension provided for under the general mandatory pension system (in 2016, €501.89 in thirteen instalments per year).

retirement loan mechanism also receive an annual refundable tax credit equal to 50 per cent of one twentieth of the interest and insurance premiums on the bank loan.[76]

In addition to the requirements noted above, the early retirement scheme for hardship categories is limited to workers with more than 30 years of contributions who belong to one of four categories needing support.[77] The benefit is not means tested and is paid in twelve monthly instalments. It is equal to the lesser of €1,500 gross and the gross pension benefit calculated at the time the beneficiary joins the scheme. Eligibility lapses if the requirements for the ordinary early retirement mechanism are met. The benefit is not subject to revaluation and is incompatible with receipt of involuntary unemployment benefits, the Unemployment Allowance (ASDI) or the indemnity for cessation of retail trade activities. Beneficiaries can also receive compensation from employment of up to €8,000 a year. Public employees who elect to apply for benefits under the programme will receive their termination benefits (however they may be designated) as from the time they become eligible for a normal old-age pension.

The planned expenditure for the early retirement scheme for hardship categories is €0.3 billion for 2017, €0.6 billion for 2018 and 2019, €0.5 billion for 2020, €0.3 billion for 2021 and €0.1 billion for 2022. According to the technical report, these expenditure limits are consistent with participation of 90 per cent of the estimated potential eligible beneficiaries. Applications to receive benefits under the scheme are in any case accepted up to those expenditure limits. For any applications above those appropriations, the start of benefit payments can be deferred in compliance with the order of priority specified in a decree of the Prime Minister but without exceeding the planned expenditure.

As regards the early retirement loan mechanism, the legislation provides for certain essential elements of the system to be determined in a subsequent decree, which among other things will incorporate agreements with ABI (for the bank loans) and ANIA (for the insurance coverage). As a result, we do not have all the information needed to assess the advantage of electing to participate, such as the interest rate and the insurance premiums that will be applied to the loan, the level of management fees and the size of the tax credit that will help beneficiaries repay the loan.

The technical report provides an estimate of the costs associated with the tax credit granted to early pensioners. The costs are rising but small through 2023 (from €8 million

[76] The total for interest expense and insurance premiums is that calculated over the entire 20-year term of the bank loan.

[77] More specifically, these are: 1) unemployed persons whose unemployment benefits have expired for at least three months; 2) workers who have assisted their spouse or a first-degree relative with a serious disability for at least six months; 3) workers with a disability of at least 74 per cent; and 4) workers who for at least six years have worked on an ongoing basis in the difficult and risky careers indicated in a specific list. Those belonging to the first three categories must also have at least 30 years of contributions, while those in the fourth category must have 36 years. Once they reach 63, those who have left work and do not already receive a direct pension can qualify for a benefit to be paid until they become eligible for a normal old-age pension.

in 2018 to €57 million in 2023), holding steady in subsequent years before gradually declining to zero as the loans are repaid or extinguished. The estimate is based on the assumption that one-fourth of all non-hardship workers (who are by definition ineligible for the hardship worker early retirement scheme) and fourth-fifths of hardship workers who do not qualify for the hardship worker scheme because they do not meet the contribution requirement will apply for the early retirement loan mechanism. Given the lack of information needed to assess the advantage of participation as well as that required to determine the size of the tax credit, it is difficult to assess the realism of these assumptions about participation and the estimated costs for the public purse. For example, high costs for interest and insurance might make participation unattractive and thereby reduce the pool of potential participants, but they would also increase the size of the tax credit.

Government working documents[78] reveal a number of details that could be confirmed in the agreements with ABI and ANIA. The annual nominal rate (TAN) on the bank loan should be set at 2.5 per cent, while the insurance premium would be the same for all participants, payable in advance (at the moment the beneficiary joins the scheme), and equal to 29 per cent of the bank loan. These terms are sufficiently onerous to limit the number of people who actually participate in the mechanism. It appears unlikely, for example, that workers in need who would be eligible for the early retirement scheme for hardship categories would apply for the early retirement loan programme if they are not accepted in the other mechanism in the presence of such access costs.

Adopting a number of simplifications, an entirely preliminary assessment of the order of magnitude of the bank loans that could be taken out through the early retirement loan programme can be conducted if we assume that, with a tax credit of a maximum of 50 per cent, twice the tax expenditure estimated for 2023 (€57 million) provides a prudent valuation of total interest and insurance premiums to be paid in 2023 to banks and insurance companies by all of those participating in the early retirement loan programme.[79] Applying the average global effective interest rate on loans repaid out of pensions (7-8 per cent) to this amount, we obtain a minimum order of magnitude of total bank loans of between €1.5 billion and €1.7 billion. Separating the associated insurance premium (29 per cent) from this amount and dividing by the average term of the advance (2.5 years[80]) and the average advance on the pension,[81] the early retirement loan scheme could effectively involve between 25,000 and 28,000 workers,

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[78] See http://www.tommasonannicini.eu/it/articles/meritobisogno-legge-di-bilancio-2017.

[79] In 2023, the last worker who joined the early retirement loan programme at the end of 2018 will have received the longest advance (3 years and 7 months). In 2023 the exposure of the banks (and, symmetrically, the total borrowing of workers) will have reached a peak. We assume that the global effective interest rate (which includes all charges and fees, including the insurance coverage, as is the case for loans repaid out of pensions) begins to be applied to this maximum value of loans.

[80] Assuming that, given the cost of participating in the early retirement loan programme, only those with at least two years to go before qualifying for regular retirement will elect to participate.

[81] It is assumed that the pension is equal to 13 payments of €1,500 gross, and an advance of 90 per cent is requested.

fewer than 10 per cent of the potential beneficiaries indicated in the government documentation.[82]

At the moment, the role and function of the guarantee fund for access to the early retirement loan programme, for which the technical report forecasts an increase in spending for 2017 only, are not clear.

The structure of the early retirement loan programme also contains two possible rigidities. Repayment of the loan necessarily begins from the time the beneficiary becomes eligible for a normal old-age pension. This means that if between the start of participation in the early retirement loan programme and the start of the ordinary old-age pension a worker should also qualify for early retirement, repayment of the loan would not begin immediately. To avoid this problem, it would have been possible to establish that for any given reduction in the requirements for the old-age pension, the early retirement loan programme would cover the monthly payments remaining before retirement and, at the request of the beneficiary, those remaining before qualification for the normal old-age pension. However, this would have had a larger impact on the public finances (INPS could have been called upon to begin pension payments early[83]). Another rigidity regards the voluntary contributions of employers to employees who opt for the early retirement loan programme. Rather than using the single lump-sum payment at the time of initial participation in the system, a more flexible alternative – and one more easily incorporated in agreements between employers and employees – would have been monthly payments, as is normally the case with pension contributions. This would have encouraged contractual solutions that maximized the advantages for employers in terms of turnover and reducing the age of the workforce. This would have offset the Budget Bill's reduction of incentives for facilitated part-time contracts prior to retirement.

As regards the early retirement programme for hardship categories, the technical report specifies that the new measure does not represent an entitlement but rather a benefit conditional on a planned spending cap and secured by a safeguard mechanism that provides for the possible postponement of the start of benefits. The planned level of expenditure, based on a reconstruction of the pool of beneficiaries, should prevent situations in which the appropriated resources are insufficient and force administrators to ration applications. However, this "faucet" mechanism does not rule out the possibility that equally eligible beneficiaries could be treated differently. Indeed, if not applied equally to all, the postponement mechanism itself is a potential source of treatment disparities, albeit less severe than would be the outright rejection of an application. This weakness has already emerged with the rules governing the protection

[82] Comprising all of those who in 2017 and 2018 are at least 67 years old and have 20 years of contributions. See http://www.tommasonannicini.eu/it/articles/meritobisogno-legge-di-bilancio-2017.

[83] It is not currently clear if participants in the early retirement loan mechanism must essentially give up the option of normal early retirement. This issue should be clarified because it impacts the advantages and costs of participation.

of workers who left work early under an early retirement scheme but are no longer eligible for a pension following pension reform, for which funding has always been found, including by way of transferring resources among categories of protected former workers. In addition, there could be a possible overlap among those eligible for the early retirement programme for hardship categories and those covered by the eighth safeguard programme (in particular, the unemployed who have been without unemployment benefits for at least three months and workers who have assisted children with serious disabilities for at least six months). A single instrument could have increased efficiency and transparency.

A final detail regards the terms of payment of the termination benefits of public-sector employees. Postponing their payment to the moment the eligibility requirements for a normal old-age pension are met makes sense only when this is the first opportunity to retire. In this case, postponement decouples the effects of the termination of service to participate in the early retirement programme for hardship categories from those of paying termination benefits. If, however, the requirements for a long-service pension are met before those for an old-age pension, logic would dictate that, together with the termination of the hardship-categories benefits, the payment of termination benefits could commence.

Temporary advance supplementary annuity (RITA). – The Budget Bill grants workers who participate in the early retirement loan scheme to convert all or part of the amounts they have accumulated in supplementary pension schemes, with the exception of those in defined benefit plans, into a temporary annuity. The annuity is paid until the time the beneficiary become eligible for a normal old-age pension and consists in the payment of part of the accumulated amount in instalments.

The advance annuity is subject to the facilitated tax treatment reserved for benefits normally paid in supplementary pension schemes: a withholding tax of 15 per cent, which can be reduced by 0.3 percentage points for each year of participation in the supplementary pension scheme in excess of fifteen years up to a maximum of 6 percentage points.[84] The RITA is open to all private- and public-sector employees, the self-employed and quasi-employees. For public-sector employees who participate in the early retirement loan programme and RITA, termination benefits are paid at the time the beneficiary becomes eligible for payment under applicable rules.

The technical report forecasts a slightly positive impact on the public finances in the first two years of application, associated with the payment of the tax on advance annuities, and an increase in expenditure as from 2019, which declines to zero in 2022, due to the fact that delayed receipt of supplementary pension benefits generates an increase in revenue from the tax on annuities later on. The estimate is based on the assumption that applicants who participate in the RITA mechanism are equal to 30, 10 and 5 per cent of those who, becoming eligible in 2017 and 2018 on the basis of COVIP data, must wait one, two and three years respectively to meet normal pension requirements within

[84] If the worker enrolled in a supplementary pension scheme before 1 January 2007, the years of previous participation are included up to a maximum of 15.

the public system. It is difficult to assess the estimate because important assumptions have not been made explicit, such as, for example, the proportion of the accumulated supplementary pension contributions that the applicants decide to transform into an annuity.

The decoupling of the requirements for access between the public- and private-sector pillars of the pension system is a positive development, which by increasing both the functional specialization of the pillars and the options available to workers, helps foster the comprehensive and balanced development of the various pension mechanisms. The introduction of such an innovation in 2000 or in 2006, the years of reform of the rules and tax treatment for supplementary pension schemes, would have given us an additional tool today, financed by real savings and not the public purse, for a flexible and gradual transition from the labour force to retirement.

Unlike a structural reform to decouple requirements between the pillars, it should be born in mind that the RITA is temporary (valid for two years), experimental and open only to workers who are eligible for the early retirement loan programme, not all participants in supplementary pension schemes. For a structural perspective, it will serve to assess whether to make the decoupling permanent or not.

There is also an inconsistency between the article in the Budget Bill that introduces this measure and that concerning the early retirement loan programme with regard to the termination benefits of public-sector workers. The former provision states that "termination or end-of-service benefits shall be disbursed at the time the beneficiary would have accrued the right to those benefits under the [previous] rules", while the latter states that "the payment of termination benefits however designated […] shall begin as from the moment the beneficiary reaches the age of eligibility [for the old-age pension]". For reasons of regulatory certainty, it would be preferable to use a single terminology when referring to the same concept.

Eighth safeguard initiative. – The Budget Bill revises the programming of expenditure in respect of the first seven safeguard initiatives for former workers who are no longer eligible for a pension following pension reform and introduces an eighth. More specifically, the INPS report on the pension safeguard initiatives published in August this year[85] found that of a total of 172,446 potential beneficiaries affected by the first seven safeguard initiatives, applications had been received from 128,079, as well as 1,949 files still to examine. Overall, assuming the unexamined applications are accepted, to date just over 75 per cent of the planned appropriation has been used.

The Budget Bill reduces the appropriation for the first seven safeguard initiatives by about 35,400 beneficiaries and more than €2.2 billion in expenditure. Excluding the reallocation of spending items for past years, between 2017 and 2023 the

[85]http://www.inps.it/bussola/VisualizzaDOC.aspx?sVirtualURL=/docallegati/Informazioni/lapensione/Documents/Report_Salvaguardie-Agg_08_2016.pdf&iIDDalPortale=11058. Law 228/2012, Art. 1, para. 239.

reprogramming generates a savings of just under €1.3 billion. Of the €642 million in savings for 2016, €592.6 million are dedicated to the Social Employment and Training Fund to fund the extended social safety net. The remainder of the savings generated by the reprogramming were designated to finance the pension measures envisaged in the Budget Bill. Any additional resources that should become available if the actual spending on the safeguard initiatives should be lower than the reprogrammed value will be allocated to the Social Employment and Training Fund.

The eighth safeguard initiative regards a pool of 27,700 workers with a total expenditure in the 2015-2025 period of just over €1.5 billion (Table 4.8).[86]

Taking account of the reprogramming in the Budget Bill, the eight safeguard initiatives involve a total of 164,800 workers and overall expenditure of €10.8 billion between 2013 and 2025 (€6 billion if we consider only 2017 to 2025).

The eight safeguard initiative is the fourth largest in terms of beneficiaries and planned expenditure and is slightly more extensive than the seventh. The underlying problem noted previously remains,[87] although so far planned beneficiaries and expenditure slightly exceed the actual numbers, the period of time for which an increase in expenditure is forecast continues to lengthen (in this case to 2024 and 2025). Among other things, comparing the reprogramming of the first seven safeguard initiatives implemented with the 2016 Stability Act with that proposed in the 2017 Budget Bill (including the eighth), we find that while costs decline in 2013-18, spending increases,

[86] The pension requirements before the "Fornero reform" (both accrual of entitlement and start of benefits) will continue to apply to: 1) 8,000 workers laid off or enrolled in the special construction industry unemployment programme as a result of governmental or non-governmental agreements reached by 31 December 2011, or, even in the absence of agreements, laid off or enrolled in the special construction industry unemployment programme by bankrupt companies, on the condition that they lost their jobs by 31 December 2012 and meet, including with voluntary contributions, the pre-Fornero reform pension requirements within 36 months of the lapse of their unemployment benefits; 2) 9,200 workers, already authorised to continue making voluntary contributions before 4 December 2011 and that meet the pre-reform pension requirements within seven years of the entry into force of that reform (6 January 2019), as long as they have at least one voluntary contribution credited/creditable as at 6 December 2011 and have not held a position in an open-ended job since 4 December 2011; 3) 1,200 workers, already authorised to continue making voluntary contributions before 4 December 2011 and that meet the pre-reform pension requirements within six years of the entry into force of that reform (6 January 2018), as long as they have at least one contribution credited from actual employment in the period 1 January 2007 - 30 November 2013 and as at 30 November 2013 no longer hold a position in an open-ended job; 4) 7,800 workers who have never again held a position in an open-ended job who stopped working by 30 June 2012 and were never again employed in an open-ended position after 30 June 2012, or who stopped working between 30 June 2012 and 31 December 2012 and were not subsequently employed in an open-ended job, or who stopped working following unilateral termination between 1 January 2007 and 31 December 2011 and subsequently never held an open-ended job, as long as they meet the pre-reform pension requirements within seven years of the entry into force of that reform (6 January 2019); 5) 700 workers who in 2011 were on leave to assist severely handicapped children and who meet the pre-reform pension requirements within seven years of the entry into force of that reform (6 January 2019); 6) 800 workers on fixed-term contracts, including temp workers, who stopped work between 1 January 2007 and 31 December 2011 and subsequently never held an open-ended job, as long as they meet the pre-reform pension requirements within seven years of the entry into force of that reform (6 January 2018). Agricultural and seasonal workers are not eligible.

[87] See PBO, (2016) "*Focus tematico n. 2*", 23 February.

albeit marginally, in subsequent years (about €200 million in 2019-2021 and €132 million in 2022, before declining thereafter) (Table 4.8).

Prompted by a desire to smooth the edges of the Fornero reform, since 2011 the safeguard initiatives have been a constant theme in the economic policy debate whose importance shows no signs of waning. The eighth safeguard measure is almost exclusively directed at workers who stopped working before 2012, or within a year of the entry into force of the Fornero reform, who would meet the pre-reform pension requirements (including through voluntary contributions) in the seven years following the entry into force of the reform, even if they have found work other than open-ended employment. There is considerable overlap with labour policies and, in particular, the scope of the new social shock absorbers introduced with the Jobs Act, from which the eighth (and seventh) safeguard initiative subtract resources. Essentially, the eighth safeguard measure is a passive labour market policy similar to those in place before the Jobs Act.

Table 4.8 – Expenditure on safeguard initiatives
(millions of euros)

Number of beneficiaries/millions of euros	Planned beneficiaries	**Planned expenditure**														
		2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	**Total**	**Total as from 2017**
Reprogramming of first seven safeguard measures with 2016 Stability Act [a]	172,466	243	934	1,871	2,593	2,438	1,676	841	465	245	114	12			**11,190**	**5,792**
Reprogramming of first seven safeguard measures with 2017 Budget Bill [b]	137,095	243	909	1,619	2,000	1,796	1,271	735	388	195	104	10			**9,269**	**4,498**
Savings from reprogramming of first seven safeguard measures [c]=[a]-[b]	-35,371		-25	-253	-593	-642	-406	-107	-77	-50	-11	-2			**-2,164**	**-1,294**
Eighth safeguard measure added with 2017 Budget Bill [d]	27,700					134	295	346	303	230	143	54	11	3	**1,519**	**1,519**
Updated programming of eight safeguard measures [e]=[b]+[d]	**164,795**	**243**	**909**	**1,619**	**2,000**	**1,930**	**1,566**	**1,081**	**691**	**425**	**247**	**64**	**11**	**3**	**10,788**	**6,017**

Source: based on data from the technical report of the 2017 Budget Bill.

Compared with the seventh safeguard initiative, the eighth contains an additional contradiction. In the pension field, the 2017 Budget Bill introduces the early retirement loan programme and the early retirement programme for hardship categories, as well as measures to facilitate retirement for workers who have physically demanding jobs or those who entered the labour force early. As a result, the same legislation has measures that reduce pension requirements, with better but not perfect targeting, and that, such as those for workers who started working early or are in physically demanding jobs, that are structural in nature,[88] as well as measures, such as the new safeguard initiative, that have no targeting and are not structural.

What is more, we must not underestimate the impact of the fact that the eighth safeguard initiative, like the earlier programmes, has not cost for those who meet the eligibility requirements for the various pools of beneficiaries, whereas the early retirement loan programme has a cost for beneficiaries. This can give rise to workers in similar situations – in terms of career and financial condition – being treated differently, such as workers who are not covered by the safeguard provisions and are forced to consider participation in the early retirement loan programme. As noted earlier, the beneficiaries who are eligible for both measures overlap with regard to the unemployed whose unemployment benefits have expired for at least three months and workers who have been assisting children with severe disabilities for at least six months.

Early retirement for workers who entered the labour force early. – For workers who qualify for defined-benefit or mixed pensions that belong to specified hardship categories[89] and who have at least twelve months of actual contributions before they reached the age of 19, the requirement for early retirement is set at 41 years of contributions 2017 and 2018, with a reduction of 1 year and 10 months for men and 10 months for women. During the months between facilitated retirement and accrual of normal early retirement entitlement, beneficiaries may not receive income from employment or self-employment. As from 2019 the facilitated contribution requirement is linked to developments in life expectancy alongside other age and seniority pension parameters. Essentially, the measure is directed at workers who started their careers early who fall into the same categories as the beneficiaries of the early retirement for programme for hardship categories.[90]

As for the latter, the facilitated treatment of early career starters does not represent an entitlement, but rather a benefit that can be granted within the limits of the associated budget appropriation. On the basis of INPS data and recent developments in early

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[88] Or at least seek to implement a structural redesign of the rules.

[89] As with the early retirement scheme for hardship categories, this group regards unemployed workers who have not received unemployment benefits for at least three months or who have been assisting a severely disabled spouse or relative in the first degree for at least six months or whose ability to work has been reduced by a disability of at least 74 per cent or who for at least six years have worked on an ongoing basis in the difficult and risky careers indicated in attachment A of the Budget Bill.

[90] The final category of workers who can qualify for the early retirement scheme for hardship categories, represented by those who for at least six years have worked on an ongoing basis in the difficult and risky careers indicated in attachment A of the Budget Bill, de facto includes other types of worker engaged in the especially tiring and heavy jobs cited in Legislative Decree 67/2011.

retirements, planned spending amounts to €0.4 billion in 2017 and €0.6 billion as from 2018. In 2017, some 20,000 early career starters are expected to opt for early retirement, with an additional 2,000 a year subsequently (the estimate of beneficiaries does not go beyond 2020).

If the volume of applicants exceeds the planned expenditure, benefits can be deferred in compliance with the order of priority specified in a decree of the Prime Minister. The accuracy of the estimates in the technical report leaves hope that this "faucet" mechanism, which is identical to that provided for in the early retirement programme for hardship categories, will not be necessary. If it should be triggered, workers with the same hardship qualifications would be subject to differentiated and discriminatory treatment.

However, unlike the "faucet" mechanism used in the early retirement programme for hardship categories, this case has a number of additional problems. First, the mechanism for early career starters is not temporary and experimental, as is the early retirement programme for hardship categories. It is instead a permanent programme, even if it is aimed at categories of beneficiaries that are slowly shrinking in step with workers in defined-benefit and mixed schemes for calculating pensions. This means that the time horizon grows longer and spending plans are more likely to be revised. In addition, the activation of the rationing mechanisms for a permanent benefit scheme of a structural nature could raise broader concerns compared with a temporary benefit system. Finally, while beneficiaries in the early retirement programme for hardship categories can move up retirement by up to 3 years and 7 months, the benefit for early career starters is 1 years and 10 months for men and 10 months for women, which can be cancelled by a postponement for two periods or one period, respectively, of the start of benefits to ensure compliance with budgeted spending.

In the light of these considerations, efforts will be devoted to monitoring take-up to ensure possible supplementary funding in the annual budget decision process and thereby avoid rationing. Once the measures have been fully implemented, it will be necessary to assess whether it is advisable to replace the formulation of the expenditure authorization in terms of a spending cap.

In general, this measure could be an important structural element of the future structure of the pension system, in which flexibility with respect to the requirements introduced with the Fornero reform (and linked to developments in life expectancy) has a cost for workers other than those in well-defined hardship categories.

Pension relief for workers in physically demanding occupations. – Workers in physically demanding jobs already benefit from an early retirement mechanism.[91] The Budget Bill

[91] In addition to compliance with the start-date windows in force prior to the Fornero reform (so-called "moving windows") eligibility for early retirement requires: 1) at least 35 years of contributions; 2) a sum of age and years of contributions (the "quota") of 97.6 for payroll employees and 98.6 for the self-employed and para-employees in 2017-2018; 3) an age of at least 61 years and 7 months for payroll employees and 62 years and 7 months for the self-employed and para-employees for 2017-2018. The workers must have

strengthens this benefit scheme with two structural and one temporary modification. The former include: 1) the replacement of the pension start-date windows with the start of pension benefits from the first business day of the month following qualification for a pension; 2) the elimination of the pre-and post-2017 distinction in the constraint on the duration of physically demanding work. The temporary change involves the suspension for workers engaged in physically demanding occupations of the updates of contribution requirements linked to developments in life expectancy for the 2019-2025 period.

On the basis of the number and characteristics of workers who have retired in the past with the relief measures envisaged for workers in physically demanding occupations, the technical report estimates a gradually increase in expenditure (from about €85 million in 2017 to more than €170 million in 2026), to be funded with an increase in the specific fund created in 2007 to permit the early retirement of specified categories of workers. The estimate appears prudent, assuming an increase of 15 per cent in the number of beneficiaries over a decade (from 2017 to 2026).[92]

With regard to funding, in 2007, in conjunction with the creation of the special fund, it was established that access to the early retirement benefit would be granted as long as there were resources in the fund. That cap has been extended by law to the new measures that workers in physically demanding occupations may receive up to the expenditure estimated in the technical report. And yet the existence of the cap is not explicitly stated in the text of the law, as it is for the early retirement programme for hardship categories and the relief for early career starters. The principles of transparency and clarity would require such specification.

Here, too, as with the programme for early career starters, the prudence of the estimated impact on the public finances could avoid the need for rationing. Nevertheless, considering that the subsidised treatment for those who work in physically demanding occupations creates a permanent exception to the pension rules, the funding structure should be strengthened. Among other aspects, compared with the rules governing early career starters and the early retirement mechanism for hardship categories, the text does not specifically rule out the creation of an entitlement and, consequently, each rationed applicant could seek immediate legal protection.

As with the provisions for early career starters, this measure is another major structural element in the future pension system, in which the requirements adopted with the Fornero reform and the link with increases in life expectancy co-exist with a permanent reduction in those requirements for specifically identified categories of workers.

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engaged in the physically demanding occupation for at least seven of the last ten years and in the last year before retirement for pensions beginning in 2017, and for at least half of their careers for pensions starting in or after 2018. The age requirement and the level of the quota are tied to developments in life expectancy.

[92] Appropriately, the report avoids optimistic assumptions about technological improvements that would reduce or eliminate the need for a human presence in the performance of physically demanding jobs.

Abolition of early retirement penalties. – As from 1 January 2018, the penalty for the defined-benefit part of early retirement pensions, equal to 1 per cent for the first year of early retirement before 62 years of age[93] and 2 per cent for each additional year beyond the first, has been repealed. The penalty is currently already suspended for early retirement pensions beginning before 31 December 2017,[94]meaning that the Budget Bill essentially makes an existing situation permanent.

The penalty was introduced with the Fornero reform[95] in order to correct the incentives for early retirement in the rules for defined-benefit pensions: when a worker retires at a relatively young age, defined-benefit (earnings-based) pensions are generous compared with contributions made during a worker's career.

On the basis of the Central Pension Register for private-sector (payroll employees, the self-employed and para-employees) and public-sector workers and recent developments in early retirement, the technical report estimates a gradually increasing cost (net of personal income tax on the pensions), rising from €23 million in 2018 to €195 million in 2026.

The measure could be seen as a step backwards in reform of the pension system, sending a message that conflicts with the objectives of extending working lives and increasing intergenerational balance pursued by the pension reform process.

Consolidation of contributions. – Compared with existing rules,[96] the measure extends the scope for no-cost consolidation of contributions by employees, the self-employed and para-employees who have accumulated contributions in more than one pension mechanism within the mandatory public pension system (excluding the separate pension funds of the professions).

Compared with current legislation, the possibility of consolidating contributions to meet old-age pension requirements has been extended to encompass workers who have already qualified for a pension in one of the various systems in which they have been enrolled. In addition, consolidation can also be used to qualify for early retirement. More specifically, each pension mechanism included in the consolidation calculates a pro-rata pension on the basis of the years accrued in that mechanism and the associated contributions and income used as a reference base, using the calculation rules of that pension mechanism (although these will converge over time).

Workers who are involved in a proceeding to combine contributions in different mechanisms against additional payments under the provisions of Law 29/1979 may, if they become eligible for no-cost consolidation, obtain reimbursement of any amounts paid. Similarly, those involved in a totalisation proceeding[97] with the recalculation of the pension on a defined-contribution basis

[93] Parameter not linked to developments in life expectancy.
[94] Decree Law 216/2011, Art. 6, paragraph 2-quater.
[95] Decree Law 214/2010, Art. 24, paragraphs 10 and 11.
[96] Law 228/2012, Art. 1, paragraph 239.
[97] Under Legislative Decree 42/2006, non-coincident contribution periods with different pension mechanisms/systems (including the pension funds of the professions) can be combined for the purposes of calculating eligibility for an old-age pension and early retirement. Each mechanism/system pays a pro-rated

under Legislative Decree 42/2006 may, subject to waiver of their right to totalisation, opt for no-cost consolidation.

Drawing on data from the Central Pension Register managed by INPS, the technical report estimates that the measure will generate gradually increasing expenditure, rising from €0.1 billion in 2017 to just under €0.5 billion in 2026. The amounts are net of tax effects (an increase in personal income tax) and the impact of the reduction in revenue in cases in which no-cost consolidation replaces the combination of contributions against additional payments.

In view of the transformation of the world of work, in which careers built on different forms of contract and professional positions as well as multiple pension systems are an increasingly frequent phenomenon, it must be seen as positive step to consider a career in its entirety for the purposes of calculating a pension, without the artificial fragmentation imposed by evolving law and institutional and organisational arrangements. In a labour market that demands ever greater capacity for flexibility and adaptation, pension rules must not penalize dynamic and mobile careers. This principle of safeguarding career continuity is even more important in a world of longer lifespans and an aging population, which will require constant adjustments of age and contribution requirements for retirement.

It is worth noting that once all pensions are calculated on a notional accumulation basis, all economic and financial differences between the three categories of totalisation, combination and consolidation (*totalizzazione, ricongiunzione* and *cumulo*) will disappear: each pension mechanism/system will be required to annuitize the notional pension pot accumulated with it.

Additional pension payment. – The Budget Bill strengthens the additional pension payment mechanism, known as the "fourteenth-month" payment, introduced with Decree Law 81/2007, providing for a supplementary benefit payment for the non-welfare pensions[98] of low-income pensioners related to contribution seniority. Under the current system, the payment was due to pensioners over 64 years of age with an income[99] of less than one and a half times the minimum pension.[100] The payment is

pension (on the basis of the beneficiary's years of contributions in that system) using the notional contribution criterion ("Dini"). In order to preserve acquired entitlements, if a worker has met the minimum requirements for a pension in one of the pension mechanisms in the mandatory public pension system (with the exception of the pension funds of the professions), the associated pension share is calculated using the normal calculation criterion in effect for that mechanism (all other shares are calculated on a defined-contribution basis).

[98] Holders of a social pension, a civil disability pension, a war disability pension or a National Workman's Compensation Institute (Inail) annuity are not eligible for the additional pension payment.

[99] Income included in the calculation comprises income subject to personal income tax (IRPEF), as well as tax exempt income and income subject to withholding tax at source or to separate taxation, including income generated abroad or in Italy with international organisations and bodies. Income excluded from the calculation includes: household allowances however denominated; mobility care allowance, imputed income from home ownership, termination benefits, and arrears subject to separate taxation. Also not assessed are war disability pensions and other special indemnities. See INPS message no. 2831 of 27/6/2016.

equal to €504 for pensions with more than 25 years of contributions, reduced to €420 for pensioners with between 16 and 25 years of contributions and €336 for those with fewer than 16 years.

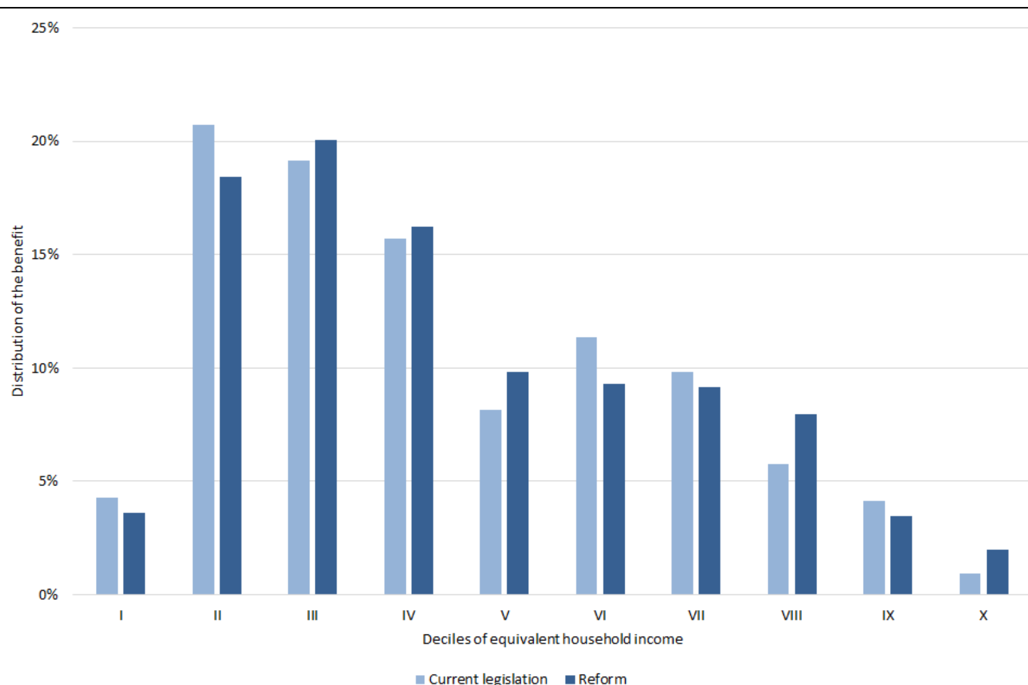
The measure was originally introduced to offset the loss of purchasing power of pensions caused, among other reasons, by the restrictions on automatic inflation adjustment in 1992-1995. At least originally, then, the system was not intended to be a welfare measure, even though for cost reasons it is mainly applied to the smallest pensions.

The changes introduced with the Budget Bill do not alter the main characteristics of the original benefit (eligibility depending on income and contribution seniority), but rather increase the amounts paid to current beneficiaries by 30 per cent and extend the pool of potential beneficiaries to pensioners with an income of between 1.5 and 2 times the minimum. According to the technical report, the measures will increase expenditure by €0.8 billion a year, increasing the number of beneficiaries by about 1.2 million.

On the basis of simulations conducted using the PBO's microsimulation model, which take account of the information in the technical report of Budget Bill regarding the current distribution of the additional pension payment, the benefits today mainly go to lower-income beneficiaries: about 50 per cent of total resources are distributed to the poorest third of the population, although the poorest 10 per cent of households receive less than 5 per cent of total benefits (Figure 4.2). In addition, since the benefit depends exclusively on personal income, pensioners who are in the richest deciles of the household income distribution because they live with high-income family members may also receive the additional pension payment: the three highest deciles receive about 10 per cent of total resources on a current legislation basis. The changes introduced with the Budget Bill will not produce any significant changes in the distribution of the benefit, which will be moderately less concentrated in the lowest income deciles.

[100] The income limit for 2016 is equal to €9,787.86. Above that threshold, the increase is equal to the difference between the additional amount and the amount exceeding the limit.

Figure 4.2 – Distribution of additional pension payments on a current legislation basis and that proposed with the Budget Bill by decile of equivalent household income



4.5 Measures for the labour market

Net resources of €0.3 billion in 2017 and €0.8 billion in both 2018 and 2019 are appropriated in the Budget Bill to finance a reduction in pension contribution rates for self-employed workers enrolled in the separate pension fund operated by INPS, the tax exemption of productivity bonuses and the tax exemption of occupational welfare measures (Table 4.9).

The reduction of pension contribution rates for workers enrolled in the separate pension fund. – The Budget Bill provides for a reduction, as from 2017, of 4 percentage points (to 25 per cent) in the pension contribution rate of self-employed workers holding VAT registration numbers enrolled in the INPS separate pension fund, as long as such workers are not enrolled in other funds within the mandatory pension system and are not already receiving a pension. The contribution rate would be 2 percentage points lower than that in force in 2016 and 8 points lower than that scheduled to take effect as from 2018. Using INPS data, the technical report estimates gradually increasing expenditure (net of tax effects) in the first three years (€108 million in 2017, €220 million in 2018 and €293 million in 2019), before levelling off with an increase of just over €300 million.

Table 4.9 – Labour market measures
(millions of euros)

	2017	2018	2019
Decreases in revenue	**-319**	**-684**	**-755**
Exemption of productivity bonuses	-209	-390	-382
Reduction in contribution rate of self-employed	-108	-292	-370
Occupational welfare	-2	-2	-2
Increases in revenue	**0**	**-72**	**-77**
Reduction in contribution rate of self-employed	0	72	77
Impact on net borrowing (1)	**-319**	**-756**	**-832**

(1) A positive (negative) sign indicates an improvement (deterioration) in the balance.

With economic activity still struggling to recover, the purpose of the measures is most likely to provide financial support to professional workers who do not belong to professional bodies. It appears to run counter to efforts in past years to gradually equalise the contribution rate with that for payroll employment (33 per cent). At the same time, the impact of the lower contribution rates should not be underestimated, as in the future it could translate into insufficient pension payments.

Another factor to consider is the fact that the reduction in contributions makes self-employed professionals less expensive for employers than payroll employees, at precisely the time the Jobs Act and the associated implementing decrees are seeking to promote the use of open-ended employment contracts and contracts within increasing protection and, above all, at a moment when contribution relief measures have been adopted to foster open-ended hiring and the transformation of other forms of contract into open-ended jobs. Following the contribution relief introduced with the 2015 Stability Act (for a total of three years, up to a maximum of €8,060 per employee a year) and with the 2016 Stability Act (two years, up to a maximum of €3,250 per employee a year), the Budget Bill renews the two-year contribution relief for employers who give open-ended contracts to students who worked with them in work-experience programmes or apprenticeships.

Overall, it must be emphasised that reductions in pension contribution rates for specific types of contract threaten to undermine the fiscal effort devoted to promoting open-ended employment relationships and stable employment for young people.

Productivity bonuses and occupational welfare measures. – The 2017 Budget Bill includes provisions that strengthen those introduced last year for the tax exemption of productivity bonuses and occupational welfare measures, i.e. the goods, services and monetary benefits that companies may provide to their employees on a voluntary or contractual basis over and above salaries and wages.

The Budget Bill increases the ceiling on the amount of variable performance bonuses[101] that is taxed separately (at a rate of 10 per cent) from personal income tax and the associated surtaxes[102] (from €2,000 to €3,000, or from €2,500 to €4,000 in the case of the equal involvement of workers in the organisation of work) and expands the number of beneficiaries, raising the ceiling on income from employment under which employees can benefit from the relief (from €50,000 to €80,000).

Under current legislation, the bonus can also be paid in the form of welfare services,[103] at the choice of the worker and on the basis of company or territorial contracts. In this case the amount does not form part of income from employment and is exempt from pension contributions[104] (however, this means the worker will accumulate a smaller pension pot and therefore reduces future pension income[105]). In addition, last year the list of types of occupational welfare benefits that do not form part of employment income was expanded and updated to include not only works and services in the fields of education, recreation, social and health assistance and religious practice voluntarily granted by employers but also those governed by company-level agreements.[106]

Under the new interpretation introduced with the Budget Bill (with retroactive effect) other benefits that do not form part of income include works and services granted under national or territorial collective bargaining agreements or inter-industry/union agreements, and the public sector is now included. The Budget Bill also broadens and extends subsidies for certain types of occupational welfare that can be offered as productivity bonuses.

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[101] Tied to increases in productivity, profitability, quality, efficiency and innovation, as well as benefits in the form of profit sharing (distributed earnings).

[102] Already applicable, unless waived by the worker, in the private sector where the bonuses are granted in performance of company-level or territorial agreements.

[103] Article 51 of the Uniform Income Tax Code (TUIR) defines income from employment for tax purposes and lists a series of components that do not form part of such income. It also lists the benefits that can be considered part of occupational welfare schemes and be used to replace performance bonuses (paragraph 2 and last sentence of paragraph 3), in certain cases with specified limits on the deductible amount (for benefits in kind, with reference to their value): more specifically, healthcare contributions to entities whose sole purpose is the provision of welfare services paid by the worker or the employer under company-level agreements for supplementary healthcare services (Legislative Decree 502/1992 as amended, Decree of the Minister of Health of 19/3/2007) up to a limit of €3,615.2; provision of food or canteen services or lunch vouchers of up to €5.29 a day, €7 if provided in electronic form, or indemnities in lieu of canteen services in some cases; collective transportation services, including passes on public transport; shares up to a limit of €2,065.83; works and services for workers and their families in the fields of education, training, recreation, social and health assistance and religious practice; educational services including those for pre-school children, and study grants for family members; welfare services for elderly or non-self-sufficient family members; expenses for deductible costs, such as payments to supplementary pension schemes by workers or employers, generally up to €5,164.57, or alimony payments to separated spouses; assets transferred and services rendered (in kind or vouchers, such as petrol vouchers) up to a limit of €258.23, beyond which that value forms full part of income. Vouchers may also be used to provide the benefits.

[104] In the case of payments by the employer to a supplementary pension fund, the employer makes a 10 per cent solidarity contribution.

[105] Mallone G., 2016, "*Il welfare aziendale nella legge di stabilità 2016: le novità per imprese e lavoratori*", in *Politiche sociali*, no. 2, pp. 359-362, notes that the earlier legislation, in force until 2014, established contribution relief for performance bonuses, which was financed through an *ad hoc* fund.

[106] Voluntary payments by the firm for these works and services are only deductible up to a limit of 0.5% of expenditure for employees, while there is no limit for the new category of benefits governed by company-level agreements.

More specifically, the provisions eliminate the ceilings on the value of shares and contributions to supplementary pension funds or healthcare entities that can be excluded from employment income and specifically envisage the possibility of receiving the bonus in the form of the assets transferred and services rendered listed in paragraph 4 of Article 51 of the Uniform Income Tax Code (TUIR) (cars and motorcycles for mixed use, subsidised loans, accommodation for use and railway transport). The measure also expands the items that do not form part of income from employment to include contributions and premiums paid by the employer, to all employees or categories of them, for services, including insurance, to counter the risk of non-self-sufficiency or contracting a serious illness.

The decrease in revenue resulting from the application of the new measures is estimated in the technical report, on the basis of final data for 2014, at about €0.2 billion in 2017 and €0.4 billion in both 2018 and 2019, while that attributable to the expansion of the types of occupational welfare measures would be negligible. Looking forward, if productivity bonuses and occupational welfare measures should take on an important role in new contracts, including national bargaining agreements, the impact could be more significant.

As regards the use of productivity bonuses and employee welfare measures, the Ministry of Labour announced the results of the monitoring of company-level and territorial agreements filed as of 15 September 2016,[107] which numbered 15,078, of which 11,003 regarding 2015 (Table 4.10).

Table 4.10 – Company-level and territorial agreements

	Company-level		Territorial		Total	
	Total	of which 2015	Total	of which 2015	Total	of which 2015
North-west	5,398	3,951	527	457	5,925	4,408
% of total	*43.3%*	*43.7%*	*20.2%*	*23.3%*	*39.3%*	*40.1%*
North-east	3,984	2,909	1,594	1,097	5,578	4,006
% of total	*32.0%*	*32.2%*	*61.0%*	*56.0%*	*37.0%*	*36.4%*
Centre	2107	1513	373	330	2480	1843
% of total	*16.9%*	*16.7%*	*14.3%*	*16.8%*	*16.4%*	*16.7%*
South	745	521	94	58	839	579
% of total	*6.0%*	*5.8%*	*3.6%*	*3.0%*	*5.6%*	*5.3%*
Islands	230	149	26	18	256	167
% of total	*1.8%*	*1.6%*	*1.0%*	*0.9%*	*1.7%*	*1.5%*
TOTAL	**12,464**	**9,043**	**2,614**	**1,960**	**15,078**	**11,003**

Source: based on Ministry of Labour data, release of 15 September 2016.

[107] Collected under the provisions of the interministerial implementing decree of 25 March 2016, which among other things requires the identification of specific criteria for measuring increases in productivity, profitability, quality, efficiency and innovation for the application of tax relief, in order to ensure verifiability.

The associated explanatory circular of the Revenue Agency was only made available in mid-June, however, and more than 1,000 contracts regarding 2016 were filed between 15 July and 15 September. Most of the contracts were company-level agreements. In addition, 11,813 pursue productivity objectives, 8,700 profitability objectives and 6,721 quality objectives, while 2,626 provide for occupational welfare measures. The share of total contracts falls drastically as we proceed from the North to the Centre and then the South of Italy.

In 2016, national collective bargaining agreements also made reference to occupational welfare measures.

For example, in the engineering sector,[108] the negotiations began to achieve consensus on issues related to supplementary pensions, supplementary healthcare, parental leave, holidays for migrant workers and leave for medical treatment (Law 104/92), while positions are still far apart on the replacement of wage increases with such initiatives.

According to Istat data,[109] in 2012 13.4 per cent of firms paid performance bonuses. In addition, 11.6 per cent of firms engaged in company-level negotiations, 9.9 per cent in territorial negotiations (often adopted in construction), and 1 per cent in group or plant-level talks. The probability of some form of supplementary contractual negotiations increases with company size and with location in the Centre and, above all, the North of Italy, while it declines in the services industry. The pay of the employees involved was 15 per cent higher than the national average and 19 per cent higher when performance bonuses were involved. In addition, Istat studied occupational welfare and corporate social responsibility initiatives (Table 4.11).

Istat inserted a special section on these issues in its monthly survey on the climate of confidence in manufacturing, market services and retail trade of February 2015. The table shows that occupational welfare initiatives defined strictly (the provision of services), measures to foster employee participation in decision making (through equity holdings or meetings on corporate activities and strategies) and social reporting are less widespread than those promoting health and safety (of course complying with legal obligations), training and in-house communication. In addition, such initiatives are found less frequently in the South, while services are most common in the Centre.

Table 4.11 – Firms that have adopted occupational welfare initiatives by macro-sector in 2014
(percentages)

OCCUPATIONAL WELFARE MEASURES	Manufacturing	Services	Trade
Foster worker participation	17.2	34.3	24.9
Provide day-care, social services, assistance, recreation or support services	17.6	30.7	4.2
Publication of social responsibility report	22.5	44.7	19.6
Flexible working hours and worker conciliation efforts	36.2	50.5	24.2
Upgrade internal communication	41.2	59.2	28.9
Professional training for employees	78.6	78.6	61.4
Safeguard workplace hygiene and worker safety	82.1	81.3	65.2

Source: Istat (2015), *Rapporto annuale 2015.*

[108] Pogliotti, G. (2016), "*Meccanici, si comincia da previdenza e sanità*", Il Sole 24 Ore of 21 October 2016, and Pogliotti, G. (2016), "*Federmeccanica punta su welfare e sanità integrativa*", Il Sole 24 Ore of 6 February 2016.
[109] Istat (2015), *Rapporto annuale 2015*.

It has been noted[110] that various forms of occupational welfare initiatives have emerged in Italy, by now involving almost all large companies (previously, those in public services were the most active) but also beginning to spread to small and medium-sized enterprises,[111] including through inter-company programmes. However, the scope of the initiatives remains narrower than in many other European countries and there are considerable differences in the presence and generosity of the projects (geographical disparities, differences by sector, firm size, type of contract and type of company). Initially, the first initiatives were supplementary pension programmes and training and education initiatives, followed by supplementary healthcare programmes, especially at the category level but on occasion strengthened at the company level. Other programmes then began to spread at the company level, such as income support, treatment and conciliation services, aid for study and the home.[112]

The OECD publishes information on tax expenditures, distinguishing between those comparable to cash benefits and those intended to foster the private supply of current benefits (excluding pensions).[113] As shown in Figure 4.3, in 2013 Italy stood in an intermediate position compared with other countries (0.8 per cent of GDP, while in 2007 it had been among the those offering the lowest levels of such benefits[114]), whereas the United States, which is notorious for its much lower level of public social spending than Europe, made the greatest use of this approach, following by Germany, which also maintains a Bismarck model healthcare system, with insurance funds.

[110] Pavolini, E., Ascoli, U. and Mirabile, M.L. (2013), "*Tempi moderni. Il welfare nelle aziende in Italia*", Il Mulino, Bologna; Pavolini, E., Leonardi, S., Raitano, M. and Arlotti, M. (2016), "*Unemployment and pensions protection in Europe: the changing role of social partners*", Observatoire social européen, Research paper, no. 21.

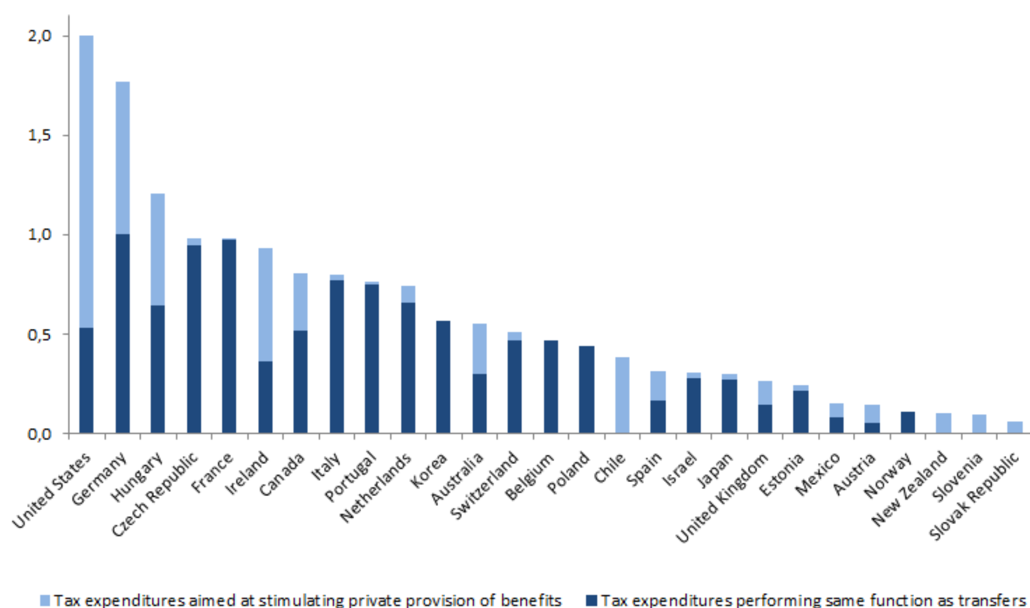
[111] It was noted that the recent *"Rapporto 2016 - Welfare Index PMI. Il welfare aziendale fa crescere l'impresa"* (prepared by Innovation Team and checked by the Steering Committee made up of representatives from Generali Italia, Confindustria, Confagricoltura, Confartigianato, Confprofessioni and experts from industry and the academic world), while acknowledging the lesser attention paid by small and medium-sized enterprises to occupational welfare initiatives, found a fairly significant body of such programmes among these smaller companies. However, the survey could be affected by self-selection issues, namely the over-representation of companies with social programmes.

[112] For more on the need for more effective governance of the sector in order to tackle the problems of fragmentation, ensure monitoring and improve the transparency and efficiency of the management of bilateral funds, see Pavolini et al., 2016, op. cit.

[113] For more on methodological aspects, see Adema, W., Fron, P. and Ladaique, M. (2011), "*Is the European welfare state really more expensive? Indicators on social spending, 1980-2012"*. The OECD (OECD, *"Social spending stays at historically high levels in many OECD countries*", Social Expenditure Update, October) finds, however, that the quality of the revenue data is not as good as that on social expenditure appropriated in the budget. The data on tax expenditures in the pension field are considered even less comparable.

[114] Adema et al. (2011), op. cit..

Figure 4.3 – Tax expenditures for social purposes in OECD countries in 2013 (1)
(percentage of GDP)



Source: OECD (2016), SOCX (Social Expenditure Database).
(1) Does not include tax expenditures associated with pension benefits.

Even though subsidised with favourable tax treatment, occupational welfare initiatives would make it possible[115] to draw private resources into social programmes, in addition to public resources, thereby expanding access to services and achieving greater efficiency, thanks to the socialisation of risk, than out-of-pocket expenditure. Moreover, they would also foster greater competitiveness through the exchange between wage moderation and welfare services (which are free of indirect wage costs and supported by tax relief), and potential productivity gains achievable through better organisation of work and closer ties between workers and companies.

In addition to the consequences of the reduction in monetary wages on the accumulation of pension pots,[116] the main problems include issues of equity associated with the emergence of a highly fragmented, unequal category-based welfare system linked to employment (and dependent on remaining in the labour market), all the more so if financed at least in part with tax expenditures borne by all taxpayers (which are regressive, given the progressivity of tax rates).[117] Work must also be done to determine whether resources devoted to encouraging occupational welfare plans could replace

[115] Pavolini et al. (2013), op. cit.; Pavolini et al. (2016), op. cit..
[116] The reduction in monetary wages would also impact the pay of new hires, perhaps encouraging employers to hire personnel on fixed-term contracts if they do not receive occupational welfare benefits.
[117] Granaglia, E. (2016), “*Il welfare fiscale. Alcuni limiti etici*”, Menabò di Etica ed Economia, n. 50, 4 October; Granaglia, E. (2011), “*I fondi sanitari integrativi: una strada da potenziare? Alcuni rilievi critici*”, in De Vincenti, C., Finocchi Ghersi, R. and Tardiola, A. (eds.), “*La Sanità in Italia*”, Il Mulino, Bologna; Dirindin, N. (1996), “*Chi paga per la salute degli italiani?*” Il Mulino, Bologna; Pavolini et al. (2013), op. cit..

universal public programmes,[118] at a time when budget constraints have tended to reduce the relative weight of the welfare state in certain traditional sectors (for example, healthcare) and limit the scope for implementing measures for protection against new social risks (for example, non-self-sufficiency).[119]

Another possibility that should not be underestimated is the emergence of collusive agreements between firms and workers for the fictitious transformation of part of ordinary wages into productivity bonuses in order to avoid ordinary taxation, a risk that is increased by the lack of a precise definition of the income components that qualify for tax relief. Among other things, the excessive use of this instrument could distort the progressiveness of personal income tax, of which one of the crucial elements is decreasing tax credits as overall income rises.

4.6 Measures for healthcare

The Budget Bill confirms 2017 funding of the healthcare system at approximately the level established in the State-Regions agreement of 11 February 2016 (€113 billion), while that for 2018 has been reduced by €1 billion compared with the agreement and that for 2019 was for the first time set at €115 billion (Table 4.12). According to the technical report, this figure implies an expenditure cut of €3 billion (calculated at the difference with the respect to the amount provided for in the State budget).

Like last year, the technical report notes that the budget targets can be achieved through spending cuts, thanks in part to the measures provided for in the Budget Bill itself, or tax increases and other automatic mechanism that would be triggered in the event of deficits. Accordingly, the impact of the measures introduced in the budget package to enhance the efficiency of expenditure is not calculated. Doing so, however, omits information needed to assess the extent to which these measures are expected to contribute to achieving the objective.

Assuming that the budget targets are achieved entirely with spending cuts and using the trend forecast reported in the Update to the 2016 EFD, healthcare spending in 2017 is stable as a percentage of GDP and falls from 6.8 to 6.4 per cent of GDP over the forecasting period ending in 2019.

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[118] It has also been noted that, apart from the case of supplementary pensions, occupational welfare does not solve the problems associated with the defined-benefit system, i.e. it does not the modify the terms of the sustainability of spending and the systemic capacity to deliver benefits. See Salerno, N. (2016), "*Quale welfare fiscale è migliore alleato del pubblico?*", Menabò di Etica ed Economia, n. 50, 4 October.

[119] Pavolini et al. (2013), op cit.; Granaglia, E. (2011), op. cit.; Granaglia, E. (2016), op. cit..

Table 4.12 – National Health Service funding and spending by purpose (1)
(millions of euros)

	2017	2018	2019
Funding of NHS (1)			
February 2016 agreement	113,063	114,998	
Budget Bill	113,000	114,000	115,000
Budget measures (2)	63	998	2,988
of which: contribution of SSRs and Aps	*7*	*108*	*322*
Purposes of funding decided in Budget Bill	**1,175**	**1,277**	**1,336**
Innovative pharmaceuticals fund (2)	500	500	500
Innovative oncological pharmaceuticals fund	500	500	500
New national vaccine plan	100	127	186
New hiring and stabilisation of non-permanent staff	75	150	150
Financing of purposes of funding decided in Budget Bill	**-1,175**	**-1,277**	**-1,336**
Resources for specific objectives of national healthcare plan	-175	-277	-336
Funding of NHS	-1,000	-1,000	-1,000

Source: based on data from the technical report of the Budget Bill and the associated schedule of financial effects.
(1) In 2016 funding was €111 billion and included an innovative pharmaceuticals fund of €0.5 billion. – (2) The figure for 2019 was calculated in the technical report as the difference with respect to the amount set out in the State budget.

On the financial level, however, the Budget Bill envisages an additional potential reduction in healthcare funding to ordinary statute regions (OSRs) already in 2017. These regions would be asked to offset, as established in the February accord, the cut provided for in the 2016 Stability Act and expected from the special statute regions (SSRs) and autonomous provinces (APs) if it not agreed individually with these authorities by 31 January 2017[120] (in conjunction with the contribution to the new cuts provided for in the 2017 Budget Bill). This amount could exceed €400 million.

The 2017 Budget Bill appropriates a portion of the overall funding for specific purposes (Table 4.12): the recent national vaccine plant; hiring of new personnel and stabilisation of non-permanent staff, to be carried out in accordance with the rules already provided for in the 2016 Stability Act;[121] the innovative pharmaceuticals fund (€500 million a year, partly funded with resources earmarked for plan objectives);[122] the innovative cancer drug fund (an additional €500 million a year).[123]

In order to fully assess the resources available to the National Health Service, we must consider the possible impact of the new governance arrangements for drugs, necessary

[120] A number of SSRs and APs have appealed the provisions of the 2016 Stability Act to the Constitutional Court.
[121] Subject to a reduction in the number of hospital beds on the basis of the rules governing hospital standards and the preparation of a staffing requirements plan, ensuring compliance with European rules of working hours through more efficient allocation of resources. Half of the extraordinary new hires can consist of stabilisations of non-permanent personnel.
[122] The previous fund for innovative pharmaceuticals (€500 million in 2015 and 2016) had been financed with resources from the restricted fund, apart from €100 million in 2015 appropriated by the State.
[123] At the same time, the classification of innovative pharmaceuticals should become more stringent.

in part to deal with the problems that emerged with the pay-back mechanism.[124] It was agreed to aggregate, for the purposes of calculating expenditure ceilings, direct distribution and distribution on behalf of health authorities (which represent direct purchases by the local health authorities) with hospital distribution (until 2016, that category of expenditure had been aggregated with normal pharmacy distribution financed by the NHS). The ceilings permitted for the two groups have also been modified as indicated in Table 4.13. In addition, expenditure for innovative pharmaceuticals will be calculated (to assess any breaches of the ceilings) on the part that exceeds the two specially created funds (as was already the case for the fund in 2016).

According to the technical report of the Budget Bill, the association of all direct purchases by local health authorities and hospitals would facilitate the traceability of data and help reduce disputes with companies. However, the report does not explain in detail the consequences of the various measures and simply affirms that the redefinition of the aggregates and ceilings would not change the overall cost for the NHS. it also appears to suggest that the innovative drug funds could increase costs, which could be offset by other savings measures, including regulation of the biosimilar pharmaceuticals market.[125] The neutrality of the revision of the ceiling mechanism with respect to the healthcare budget could be plausible, but the outcome will depend on developments in the composition of expenditure between normal pharmacy distribution, direct distribution and hospital distribution. In any event, the charge of €500 million for the NHS associated with the retention and increase in funds for innovative drugs, which the regions must offset with compensatory measures, would remain in place. The effects of the new regulations for the biosimilars market are not clear.

Litigation has emerged in this field as well, with particular regard to the measures adopted by the regions concerning the replaceability of original biologics with less expensive biosimilars and the organisation of tenders. The Budget Bill establishes that the determination of biosimilarity between pharmaceuticals shall refer to the European Medicines Agency (EMA), and in any case does not permit the automatic substitution of biosimilar drugs, nor tenders simultaneously involving products with different active ingredients, even if they have the same therapeutic indications. Public purchasing procedures will involve the specification of framework agreements with all producers of the active ingredient, while the starting price for the auction is the maximum price charged to the NHS for the original biologic, and physicians can choose among the three drugs ranked highest in terms of lowest price or most economically advantageous bid, using other products to ensure therapeutic continuity if necessary. When the patent on a biologic expires, even if during the term of a contract, the contracting entity must hold a new auction with any new biosimilars available for sale. Any costs created by failure to comply with these requirements cannot be charged to the NHS.

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[124] I.e. the repayment of breaches of spending ceilings through payments from the firms involved. The application of this mechanism by the AIFA (Italian Medicines Agency) has been the object of considerable litigation.

[125] Drugs comparable to a previously authorised biologic whose patent has expired.

Table 4.13 – Pharmaceuticals expenditure ceilings
(percentage of financing)

	2016	2017
Hospitals	3.5	
Territorial (normal pharmacy + direct and on behalf Class A)	11.35	
Direct purchases (hospitals + direct and on behalf Class A)		6.89
Normal pharmacy distribution		7.96
Total pharmaceuticals	**14.85**	**14.85**

Another measure impacting the regulatory arrangements of the NHS consists in an experimental increase in the bonus component, which is subject to successful verification of compliance with regional objectives,[126] set at 0.1 per cent of additional funding.

This component will be connected with the proposal submitted for an annual improvement and development programme to the Committee for Essential Care Standards by each region for specific areas of the NHS,[127] based in part on the opinion of that committee and the results of the guarantee system for health protection objectives provided for Legislative Decree 56/2000. The failure to prepare that programme disqualifies a region from receiving the bonus, as would a negative finding in the annual verification of its implementation.

The additional measures to achieve savings regard purchases of goods and services, improvements to electronic performance monitoring and control systems and tightening the rules governing the financial recovery plans of NHS units.

Increasing the efficiency of purchasing would be achieved through application of the measures for rationalising expenditure on goods and services established for all government departments. These include the establishment of a committee and the drafting of guidelines on tender procedures (including the specification of bands of auction starting prices) and the regulation of cases in which it is not possible to use central purchasing bodies. The upgrading of the Electronic Medical Record[128] and the regional patient pharmaceutical use histories will be implemented with the use of the infrastructure and data of the Health Card System operated by the Ministry for the Economy and Finance, with the possible appointment of special commissioners to run non-compliant regional systems. The financial distress conditions that trigger the implementation of recovery plans for NHS units (2016 Stability Act)[129] will be tightened, making the plans mandatory for deficits exceeding 5 per cent of revenue (rather than 10 per cent) or €5 million in absolute value (rather than €10 million).

Ultimately, the 2017 Budget Bill could increase certain costs, especially for the OSRs, which would be covered by implementing larger cuts than those envisaged in the technical report. As regards the allocative aspects, the part earmarked for hiring seems limited and

[126] The bonus is currently set at 3 per cent of ordinary financing of the general fund (unrestricted), and 2 per cent for regions that have been compliant in the last three years.
[127] For regions under a recovery plan, this is intended to supplement the operational programme for the pursuit of that plan if necessary. In this case, the annual programmes must be approved by the ECS Committee together with the compliance verification table.
[128] This reports health data and information on clinical events involving individual citizens.
[129] In this regard see PBO (2015), *"2016 Budgetary Policy Report*", November. The implementing decree was issued in June.

there is no additional funding for new contracts. In addition, most of the earmarks direct resources for spending on pharmaceuticals. The centralised decision on how to use part of healthcare resources seems designed to meet certain widely felt needs (for example, curing hepatitis C and oncological diseases), but it is not clear whether that choice is consistent with the need for more traditional services to operate. If reconciling these objectives is probably to be sought through greater efficiency in managing these services, although the technical report does not quantify this effect, we must not neglect the effort to achieve greater cost effectiveness in the pharmaceuticals area, including innovative drugs.[130]

4.7 Measures for families and fighting poverty

The Budget Bill's measures to support families are of modest scale, fragmented and insufficiently means tested. More specifically, they include a grant of €800 to women in the seventh month of pregnancy or who are adopting a child, an allowance of €1,000 a year for day-care, financing of baby-sitting vouchers for child care and refinancing of the Birth Support Fund. In addition, the year of mandatory leave for working fathers was extended for one year. Overall, the impact on the public finances is put at €0.6 billion in 2017 and €0.7 billion in 2018 and 2019. These measures should be assessed in the light of the family support measures now being examined by Parliament. They would accompany, and in some cases be in addition to, existing programmes, subtracting resources from efforts to achieve other unmet objectives.

Tax credits for building renovations and energy efficiency upgrading are extended and strengthened, and new relief for spending on seismic upgrading has been introduced, with an overall impact on net borrowing of €0.7 billion in 2018 and €1.5 billion in 2019.

Section II of the Budget Bill also provides for the refinancing of the cultural spending grant for 18-year-olds (€0.3 billion in 2017) and the poverty fund (€0.5 billion in 2018 and €0.3 billion in 2019).

4.8 Measures to fight tax evasion

The Tax Decree contains structural measures to fight VAT evasion and strengthen tax collection efforts. It also envisages one-off measures, such as the facilitated settlement of tax arrears accumulated between 2000 and 2015 and an extension of the voluntary disclosure procedure. Including the measures in the Budget Bill (which includes the quantification of the greater revenue expected from voluntary disclosure programme),

[130] Turati, G. (2016), "*Spesa sanitaria: il governo è realista. Forse fin troppo*", lavoce.info, 2 November.

these provisions are expected to generate €6.1 billion in extra revenue in 2017, €5.8 billion in 2018 and €4.0 billion in 2019 (Table 4.14).

Quarterly VAT reporting. – The Tax Decree provides for the replacement as from 1 January 2017 of the existing VAT transaction report (which required the reporting of VAT data on an annual basis, following the close of the tax year)[131] with quarterly reports by parties required to levy VAT containing detailed data on all invoices issued and received (indicating, among other details, the VAT rate applied) and summary data on periodic settlements of the VAT liability. Failure to comply is subject to a fine of €25 for each invoice omitted up to a maximum of €25,000.

The primary objective of the measure is to counter so-called non-consensual tax evasion, i.e. evasion by only one of the parties in business-to-business transactions. The transmission of quarterly VAT reports will enable the Revenue Agency to cross-check customers and suppliers during the year (within one month of the quarterly reports) rather than having to wait for the annual VAT settlement (the deadline for which has been shifted from 28 February to 30 April) and the annual reports of the balance of invoices issued and received. The intention is to accelerate automated audits and the collection of omitted payments through the procedure for the voluntary amendment of returns.

Table 4.14 – Measures to fight tax evasion
(millions of euros)

	2017	2018	2019
Increases in revenue	**6,065**	**5,518**	**3,958**
Strengthening collection efforts	0	483	483
Quarterly reporting of invoices and VAT settlement data	2,110	4,230	2,770
VAT tax warehouses	150	200	200
Facilitated settlement of tax arrears (2000-2015)	2,000	400	300
Extension of voluntary disclosure mechanism(1)	1,600	0	0
Anti-avoidance rules concerning customs warehouses	100	100	100
Provisions concerning tax warehouses for energy products	105	105	105
Increases in expenditure	**0**	**245**	**0**
Tax credit for technology upgrade for VAT reporting	0	245	0
Impact on net borrowing (2)	**6,065**	**5,763**	**3,958**

Source: based on data from the technical report of the 2017 Budget Bill and the Tax Decree (Decree Law 193/2016).
(1) As reported in the schedule of the financial effects of the Budget Bill. – (2) A positive (negative) sign indicates an improvement (deterioration) in the balance.

[131] The original version (Decree Law 78/2010, Art. 21) required the electronic notification of the Revenue Agency of all VAT-subject transactions with a value of at least €3,000 net of VAT (€3,600 for transactions for which the issue of an invoice was not obligatory) by 30 April of the following year. In the current version (Decree Law 16/2012, Art. 2), the reporting requirement (by the same deadline) regards all invoices issued and received from each customer or supplier. The mandatory reporting of transactions for which an invoice is not mandatory with a value of at least €3,600 including VAT is not affected. Parties who elect the electronic transmission of invoices and payments are not subject to the VAT transaction reporting requirements.

According to Government estimates, this measure is expected to generate an increase of €2.1 billion in revenue in 2017, €4.2 billion in 2018 and €2.8 billion as from 2019. Of this, €1.4 billion in 2017 and €2.8 billion as from 2018 would be the result of a structural increase in voluntary compliance and a reduction in omitted payments.[132] According to the technical report, the remainder of the expected revenue increase (€0.7 billion in 2017 and €1.4 billion in 2018) would be generated by the acceleration of automated audits and the payment of arrears assessed in audits of annual returns for 2014 and 2015. The estimate is exposed to a degree of uncertainty connected, among other things, with the extent to which the fight against tax evasion in business-to-business transactions, the primary objective of the measure, does not encourage VAT-liable businesses to engage more aggressively in consensual evasion (i.e. when there is an agreement between buyer and seller) or expand evasion to transactions with consumers.

In addition, it is not clear why the revenue connected with the audits of annual returns for 2014 and 2015 is correlated with the measure introduced in the decree: the annual reports of invoices for 2014 and 2015 should have already been submitted in 2015 and 2016, respectively, and already be under examination by the Revenue Agency and therefore already reflected in current legislation. In general, the accounts on a current legislation basis should already reflect for the years following 2016 revenue that theoretically should have been collected following existing annual audits. Nevertheless, it is not excluded from the expected revenue generation of this measure. Moreover, there is no quantification of the reduction in revenue connected with the elimination of the notification of data concerning contracts entered into by leasing companies, as well as the elimination of the presentation the lists summarising intra-EU sales and purchases, which were associated with possible revenue at the time of their introduction in the legislation.

When the requirement for electronic submission of VAT-subject transactions with a value of more than €3,000 was introduced in 2010 (Decree Law 78/2010, Art. 21), the technical report estimated an increase in revenue – excluding the indirect impact on direct taxes and in relation to the increase in compliance only – of about 60 per cent of that now expected in the first year and 40 per cent of that in subsequent years. The documentation requirements of the law were considered excessively onerous for firms and replaced in 2012 with a requirement to report only the overall value of invoices issued and received by customer and supplier.

The measures envisaged in the Tax Decree are a step in the right direction for strengthening the tools available in the fight against VAT evasion. However, they have a number of problems. First, they increase compliance costs for taxpayers. This burden is partly offset by the elimination of other requirements (the notification of information on contracts entered into by leasing companies and transactions with black list countries, as well as the presentation of summary lists of intra-EU sales and purchases) and the creation of a tax credit of €100 for each taxpayer with revenue of less than €50,000 for the technology upgrades necessary to submit the reports.

[132] The Government estimates include an indirect increase in revenue from direct taxes of €0.3 billion in 2017 and €0.6 billion as from 2018.

Second, the penalties for non-compliance, which are not proportionate to the value of omitted invoices, seem too light to have an effective deterrent effect for non-compliant taxpayers. In addition, the reporting requirement only concerns registered invoices – ignoring those for VAT-exempt and non-deductible transactions - and permits the cumulative registration of invoices for less than €300 in a single monthly summary document. This means there will necessarily be a mismatch between reported invoices issued and received generated by the differences in the timing of the registration of purchases and sales, limiting the effectiveness of the Revenue Agency's controls.

Finally, while the new procedures for reporting VAT data do counter tax evasion in business-to-business transactions, they do not confront the problem of evasion downstream, in sales to final consumers.[133] It would be advisable to extend the requirement for electronic invoicing and the reporting of payments (register receipts) for parties not required to issue invoices (retailers, restaurants, etc.), although this would involve new compliance burdens for small operators. Without extending reporting requirements to the final stage and in the absence of controls on the profit margins of retailers that prevent the latter from reporting smaller profits than they actually earn, tax evasion at the final stage of the transaction chain threatens to undermine, if not worsen, the impact of the measure.

Elimination of Equitalia. – As from 1 July 2017, the companies of the Equitalia group will be dissolved and their national tax and contribution collection duties consequently assigned to a new state-owned economic agency – the Revenue Collection Agency – which will take over Equitalia's legal relationships. In order to enhance tax collection efforts, as from 1 January the Revenue Collection Agency will be allowed to use the databases available to the Revenue Agency and gather information directly from INPS on work and employment relationships, to be used in establishing liens on salaries and other forms of employment income. The measure is expected to increase revenue by €0.5 billion as from 2018.

The Revenue Collection Agency will hire the personnel, subject to their passing a specific selection procedure, of the dissolved group other than seconded government department staff. The latter will be transferred to the position originally held in government or, if no position is available, to another government department.

At the same time, the termination of Equitalia's tax collection activities for municipalities and the companies in which the latter have invested has been postponed from 31 December 2016 to 31 May 2017. Local authorities must decide whether to use the national collection agency (Revenue Collection Agency) by 1 June 2017 and then decide whether to renew the engagement by 30 September each year. The need for annual decisions by local authorities to renew the engagement of the collection agency may not

[133] To encourage reporting of tax evasion in retail transactions, the only mechanism provided for in the 2017 Budget Bill is a lottery, as from 2018, with drawings of register receipts, copying similar initiatives in other countries.

be appropriate to the efficient management of the service, which could instead be better run on the basis of longer-term plans.

The objective of this operation is to unify the assessment and collection of taxes, generating economies of scale, more timely communication and use of a single information base, partly in response to the comments of leading international organisations. As recently emphasised in the hearing of the CEO of Equitalia,[134] this would bring the Italian system into line with that adopted in the main European countries (France, Germany, United Kingdom and Spain). However, it must be emphasised that part of the problems that currently afflict tax collection (inefficiency, the characteristics of the work of collection agents, the recent contraction in recovered revenue) should be attributed not so much to Equitalia itself as to the set of rules that governs its activity. In this light, what is urgently needed is an overall review of the tax collection approach, consistent with the recommendations of international organisations and the best practices adopted in other countries.

Amnesty for tax arrears. – The budget package also makes provision for the facilitated settlement of tax arrears cases in the hands of tax collection agents for the years between 2000 and 2015.[135] More specifically, taxpayers can settle their tax liability by paying only the principle amount and statutory interest, the commission due to the collection agent and the costs of notices sent. They will not have to pay penalties, default interest or the penalties and other amounts normally due on pension arrears.

The mechanism does not cover own resources of the EU, amounts due for the recovery of state aid, receivables generated by rulings of the Court of Auditors, pecuniary penalties connected with convictions and administrative penalties for violation of the traffic code. In order to participate, taxpayers must submit an application by 22 January 2017 and specify the number of instalments in which the liability will be paid (a maximum of four instalments[136], of which the third and fourth must be paid by 15 December 2017 and 15 March 2018, respectively). In the event of non-, insufficient or late payment, taxpayers lose their eligibility to participate in the relief system and will have to pay the entire amount due in a single instalment. Taxpayers who have already begun to pay their tax liability in instalments can also qualify for the mechanism, as long as they continue to pay instalments until December 2016. In this case, amounts already paid in penalties and interest cannot be recovered.

This measure is expected to generate €2.0 billion in additional revenue in 2017, €0.4 billion in 2018 and €0.3 billion in 2019. Assessing this estimate is made more complex and uncertain by the lack of detailed information on the value of unrecoverable positions – which increasingly numerous the further in the past they are – involved in insolvency proceedings or precautionary or enforcement actions under way, indigent debtors, dissolved companies or deceased persons. The technical report would have been more transparent if rather than applying past participation rates reduced

[134] See the hearing of the Chief Executive Officer of Equitalia SpA of 2 November 2016 before the joint Budget and Finance Committees.
[135] During parliamentary ratification of the Tax Decree as law, the programme was extended to 2016.
[136] The first two instalments will each be equal to one-third of the total amount due; the third and fourth instalments will be equal to one-sixth of the total.

discretionally to the entire mass of positions in arrears since 2000 it had instead reported the number of positions considered enforceable for each year and then applied participation rates actually registered in the recent past.

The expected revenue must be evaluated in terms of the financial benefit to the taxpayers: although they will benefit from the elimination of penalties and interest, they will have to pay their arrears in an extremely short period of time (5 quarters) compared with the 72 instalments (6 years) permitted under existing instalment options. The attractiveness of the amnesty will clearly be greatest for those who committed offenses that only involve the payment of penalties and interest (for example, those who fail to complete the schedules in their tax returns concerning investment and assets held abroad). In other cases, the savings from the amnesty mechanism would be considerably smaller.

Even considering these differences in benefit among taxpayers, the measure, in cancelling penalties and default interest, still ends up rewarding less deserving taxpayers, and thus serves to weaken taxpayers' sense of a tax compliance duty.

One specific critical aspect of the measure, which should however be eliminated during parliamentary consideration of the Tax Decree, is the impossibility of facilitated settlement of fines and local taxes of municipalities that do not use the tax collection services of Equitalia (in 2015, about 55 per cent of the total).

Extension of the voluntary disclosure mechanism. – The measure provides for the extension of the deadline for participating in the voluntary disclosure mechanism for taxpayers other than those who participated in the previous edition,[137] which regarded violations committed before 30 September 2014, who violated obligations to report assets and investments held abroad. Curable violations are those committed before 30 September 2016. Like the previous edition, the relief mechanism can also be used for reporting violations for assets held in Italy, for the purposes of income tax and associated surtaxes, separate taxation, regional business tax and VAT, as well violations concerning tax withholding returns. Specific provisions govern cases in which the voluntary disclosure involves cash or bearer instruments.

The procedure has been changed, however: taxpayers can elect to participate in the voluntary disclosure mechanisms until 31 July 2017 and submit the associated documentation by 30 September 2017. They will have to make payment in a single instalment by 30 September 2017 (or at most three instalments, of which the first by this date) of all amounts due in respect of taxes, withholdings, contributions, interest and penalties.[138] In the case of failure to pay or

[137] During parliamentary ratification of the Tax Decree as law, these taxpayers were allowed to participate in the voluntary disclosure scheme.

[138] In the previous version of the voluntary disclosure mechanism taxpayers had to submit an application to the tax authorities that specified in detail the investments and financial assets established or held abroad, including those held indirectly or through trustees. It was necessary to submit documentation that enabled reconstruction of the income used to establish or purchase these investments and any proceeds generated from their sale or use. Subsequently the Revenue Agency issued an assessment or a summons to voluntarily comply containing the amount due from the taxpayer.

insufficient payment, the Revenue Agency will issue a summons and the taxpayer will be required to pay penalties, which differ depending on whether the case involves a failure to pay or insufficient payment and, in the latter case, the difference in the amount paid from the amount due (an increase of 3 per cent or 10 per cent). Municipalities must also notify the Revenue Agency of taxpayers who apply for entry in the registry of Italians resident abroad (AIRE). Initially the notification will also include those who have applied for entry in that registry since 2010 and have not submitted an application for participation in the voluntary disclosure mechanism.

The 2017 Budget Bill puts the expected revenue from the voluntary disclosure mechanism presented in the Tax Decree at €1.6 billion in 2017 (of which €0.6 billion from applying the procedure to cash and bearer instruments). A safeguard clause is also introduced against the eventuality that the monitoring of the measure should reveal a shortfall in revenue from the expected level. More specifically, it provides for a reduction in appropriations in department budgets.

The revenue expected from the voluntary disclosure mechanism is exposed to a degree of uncertainty. The expected increase in revenue represents just over 40 per cent of that achieved in the first edition. Considering the fact that the Tax Decree presented in Parliament excludes those who participated in the previous edition and that the eligibility criteria for participation are substantially unchanged on those for the first edition of the measure, the expected revenue could be overstated. However, alongside the bolstering of anti-tax-evasion efforts at the international level, another countervailing measure will be the entry into force as from next year of the Common Reporting Standard (CRS), which will enable tax authorities to receive information from financial institutions on accounts held with them and permit the automated exchange of that information among the tax authorities of more than one hundred countries.

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